DK

NEW EDITION

50% OF AGREED DEALS ARE NOT CLOSED

300% INCREASE IN INTERNATIONAL TRADE BETWEEN 2010 AND 2020

A PRODUCT CAN BE LABELED AS "NEW" FOR 6 MONTHS

ONLY 15% OF EMPLOYEES ARE FULLY COMMITTED TO THEIR JOBS

60% OF EUROPEAN COMPANIES ARE FAMILY OWNED

HOW BUSINESS WORKS

84% OF JOB SEEKERS SAY A COMPANY'S REPUTATION MATTERS

THE FACTS visually explained

42% OF BUSINESSES FAIL DUE TO POOR DEMAND FOR THEIR PRODUCTS AND SERVICES

HOW BUSINESS WORKS

About this eBook

Due to the complex integration of images and text, this DK eBook has been formatted to retain the design of the print edition. As a result, all elements are fixed in place, but can easily be enlarged by using the pinch-to-zoom function.

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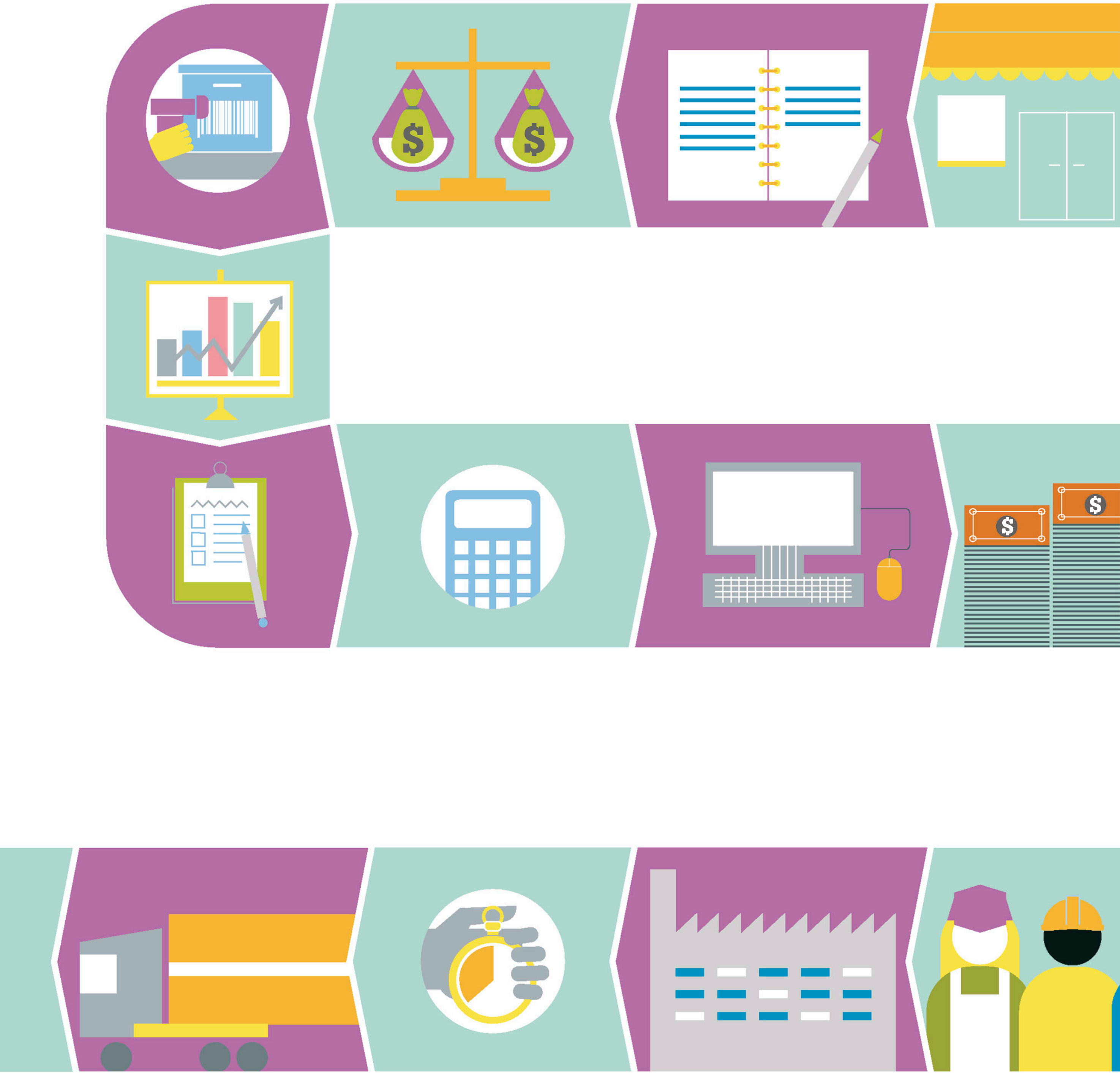
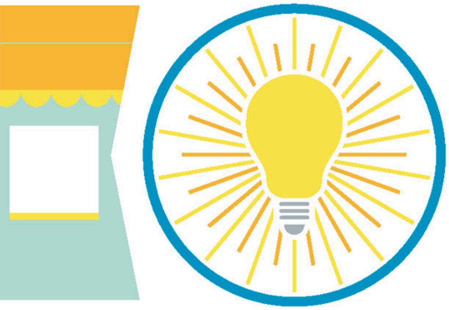
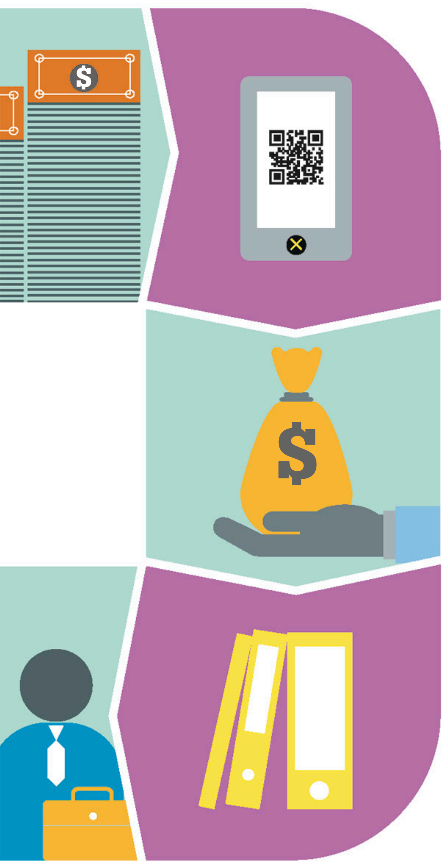




HOW BUSINESS WORKS

The FACTS visually explained



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Contents

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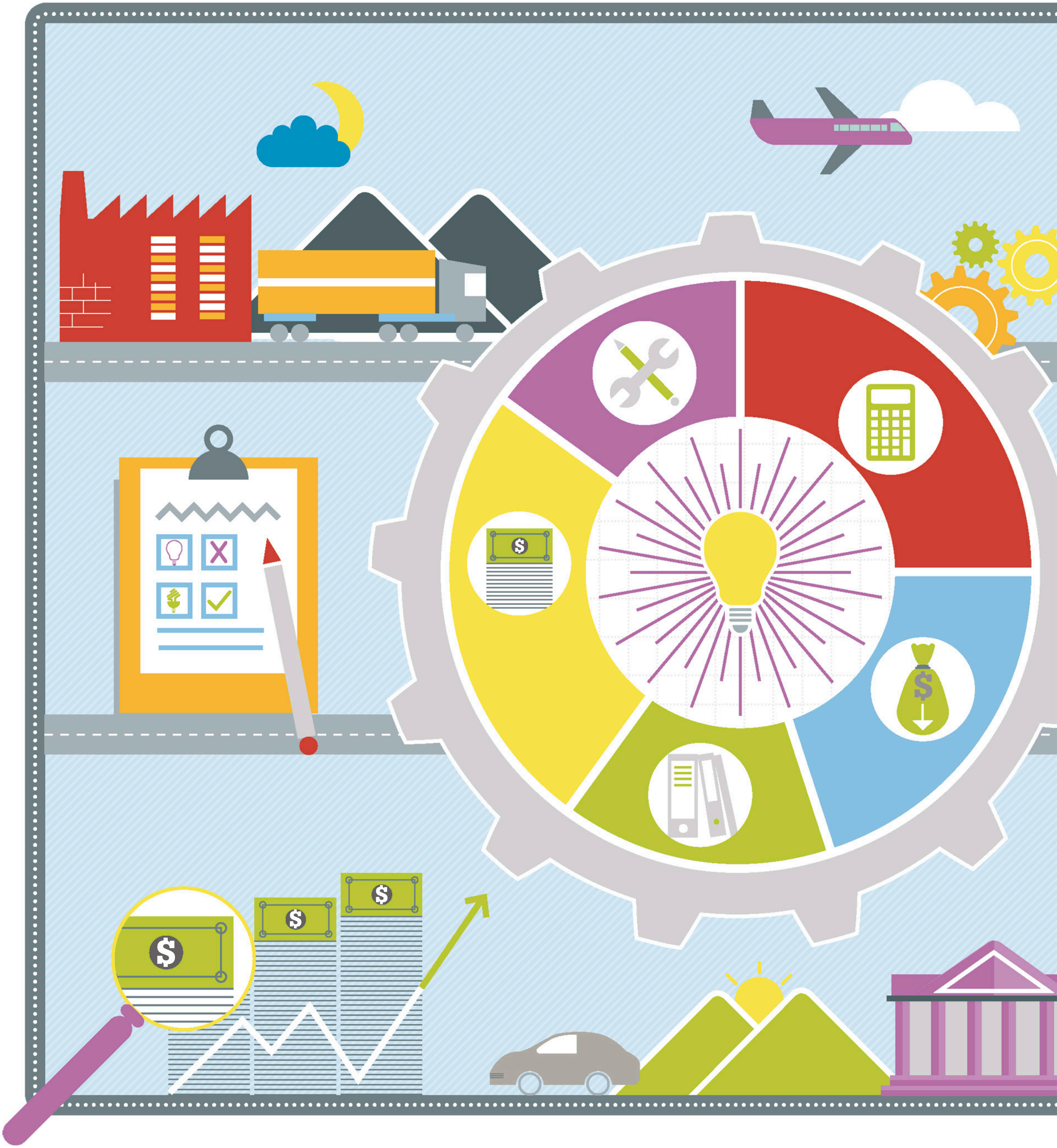
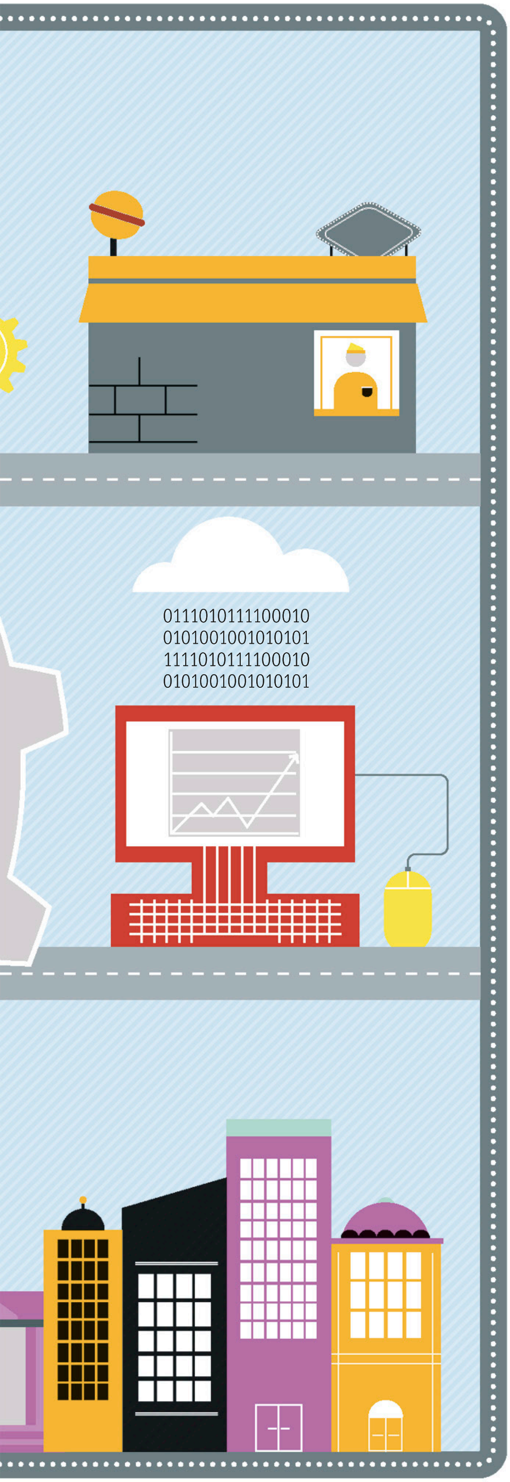




Introduction

The term "business" refers to an organization or commercial enterprise engaged in producing and trading goods and services for money. We can trace the origins of business to the very foundations of human society. When *Homo sapiens* evolved, humankind left behind the nomadic hunter-gatherer lifestyle to become farmers. This allowed for specialization of work, where individuals would become skilled at specific tasks to serve a particular community need. Over time, this enabled more complex goods and services to be produced and traded in order to provide for all members of society. Thus, human society has been engaging in "business" for thousands of years.

Today, the world of business is inescapable—businesses no longer are just local providers of goods and services but extend to vast corporate enterprises operating on a global scale. At the same time, technological advances have made it easier than ever for entrepreneurs to start their own companies and propelled Internet-based businesses to the heart of the global economy. But whether businesses are small or large, public or private, for profit or nonprofit, they each play a key role in allowing governments to function and economies to flourish, and together they form the backbone of the modern world. Business underpins every aspect of the world we live in today, and understanding how it works is the key to understanding society.

This book explains the complex world of business in a simple and graphic way. It examines every aspect of how a business works, including forming a company, raising capital, product development and marketing, management strategies, tracking revenue, financial reporting, and legal, social, and environmental responsibilities. Through visual explanations as well as real-life examples to make even the most complex concept immediately accessible, *How Business Works* offers a clear understanding of what business is all about and how business, in its many forms, shapes modern society.

HOW **COMPANIES** WORK

Business ownership ❯ Start-ups
Buying & selling businesses ❯ Who's who
Corporate structure ❯ Human resources

Business ownership

Every type of business has to choose an ownership structure. Although there are global variations, most countries offer analogous legal entities, from a single-person private enterprise to a large organization trading on a stock exchange. There are three key considerations: how big the venture is expected to grow; the complexity of financial recording, management, and reporting that the owner is willing to take on; and the amount of liability that the owner is willing to accept.

Small and simple

- Basic structures, such as a sole trader or partnership, are simple to set up and require little capital.
- One or more people own the business—usually a small enterprise—and trade as a legal entity.
- Owners are personally liable for business debts. *See pp.14–15.*

Private companies

- More complex to set up and run, private companies are legal entities that are separate from their owners. They may have some financial reporting obligations.
- Owners are not usually personally liable for business debts.
- Shareholders, who are often the companies' managers, own them. *See pp.16–19.*

Public companies

- Companies that go public are large businesses, and they have many legal and financial reporting obligations.
- The general public and other institutions can buy shares in public companies.
- The public company structure is good for a major capital injection, allowing the business to expand. *See pp.16–19.*

7%

of global economic activity is accounted for by the world's 100 largest companies.

NAMING A COMPANY

Do

- **Use a domain suggestion tool** to search for available internet domain names and work backward from there.
- **Be descriptive** so potential customers instantly grasp the nature of the business.
- **Say the name out loud**, as it may sound different than intended. The goal is for people to find it just from hearing it.
- **Check what the name means** in other languages.
- **Keep it short** and simple and avoid puns.

Don't

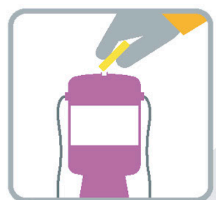
- **Include your name**, so if the venture fails, your name will be associated with it.
- **Copy competition**, because if your name is unique, you have a much better chance of topping search-engine results. If your name is similar to that of competitors, customers can't tell you apart from them.
- **Spend time** thinking of a name until your product and brand are finalized. Get the product right first, and the name will naturally follow.

Multinationals

- Multinationals have operations in various countries, enabling growth and flexibility.
- Multinationals can save money by setting up operations in countries where costs are cheaper.
- Foreign branches can adapt to the local market and also find new markets. *See pp.20–21.*

Franchises

- In this model, a business (the franchisor) authorizes an individual (the franchisee) to set up a branch, in return for a fee.
- The franchisor needs less capital than it otherwise would to develop the business.
- The franchisee takes on a known, successful business model and name, minimizing the risk. *See pp.22–23.*



Not-for-profit sector

- Common not-for-profit organizations include charities, mutuals, and cooperatives.
- Their organizational structure is similar to that of a company.
- NPOs may generate substantial sums of money but reinvest it in beneficial causes rather than distribute profits. *See pp.24–25.*

Sole proprietorships and partnerships

The simplest business structures are those formed by one person as a sole proprietorship or by two or more people as a partnership for commercial activity. Many cost little to set up, and some are easy to run.

How it works

Many businesses start out as the most basic unit—either a sole proprietorship or a partnership. A sole proprietor is an individual who is the only owner of the business. This structure is easy to set up, and there are no extra taxes to pay, unlike with a company. Instead, the sole proprietor files a personal tax return. There is risk attached, though. A sole proprietor has unlimited liability, so if the business fails, the owner must personally pay debts. Partnerships have more than one owner, and each can be held liable for the whole debt of the business in case of failure.

NEED TO KNOW

- **Firm** Collective term for individuals in a partnership
- **Limited liability partnership (LLP)** Partners not personally accountable for business debts

Unlimited liability: business debts paid personally

Tax-efficient way to be self-employed

Simple registration process

Little capital needed

Easy to move from sole proprietor to company status

Schedule C filed with IRS Form 1040

Trade under own name or chosen business name

Keep all business profits after paying tax on them

Pros and cons

Both sole proprietorships and partnership structures are excellent for anyone starting out or running a small business—as long as partners have a good working relationship and the business stays out of debt: owners are personally liable for business debts.

Sole proprietorship

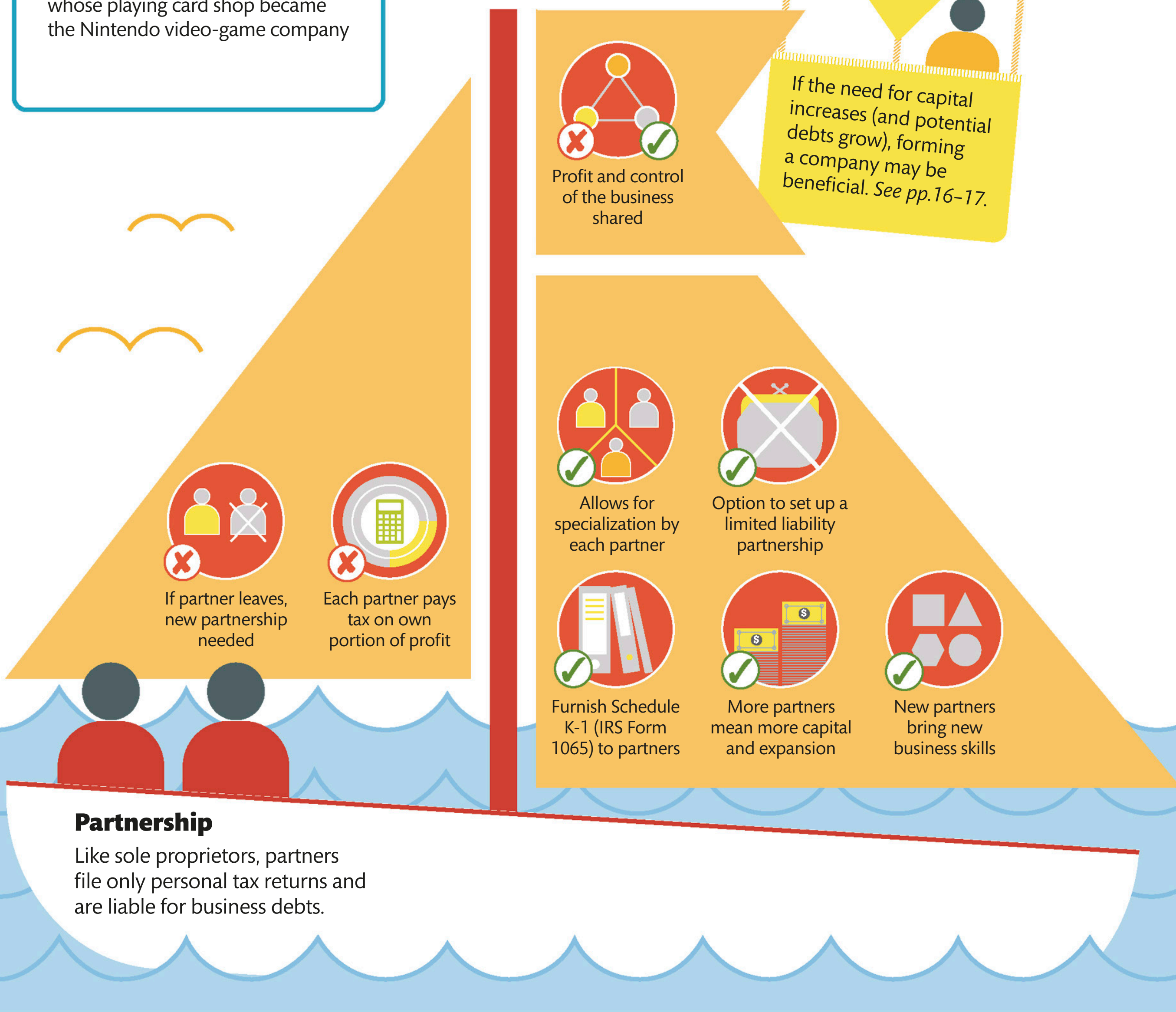
Working alone requires only simple administration and relatively few start-up costs.

FROM INDIVIDUAL TO MULTINATIONAL

Sole proprietorships and partnerships may grow into global names.

- **Richard Branson** Sole proprietorship that expanded into Virgin empire
- **Steve Jobs and Steve Wozniak** Partnership that created Apple brand
- **Bill Hewlett and David Packard** Partners who founded HP technology
- **Fusajiro Yamauchi** Sole trader whose playing card shop became the Nintendo video-game company

66% of E.U. private-sector jobs are in small or medium-size enterprises.



Partnership

Like sole proprietors, partners file only personal tax returns and are liable for business debts.

Limiting liability

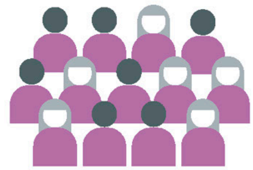
By setting up an organization that is legally and financially independent business owners can limit their level of risk, as personal assets are largely protected.

How it works

Business owners can structure their business so that it is legally the same entity as the owner (sole proprietorship), or they can choose a structure that is a separate legal entity (limited partnership, corporation, or limited liability company [LLC]). Choosing one of these limits the owner's personal liability for debts and protects them from the risks of running a business. LLCs and corporations are by far the most common for small businesses and entrepreneurs because of the tax implications. An LLC is less structured and has fewer reporting requirements than a corporation, so many entrepreneurs choose it. A corporation has more reporting and structural requirements, but it also provides more protection from liability for the owners. There are several different types of corporations that an owner can register as, but all issue shares of the corporation and the owners become shareholders, with the profits of the corporation distributed as dividends.

US business structures

The four main business structures in the US are: sole proprietorship, limited partnership, corporation, and limited liability company (LLC). A sole proprietorship treats the business as the same as the person who owns it, and does not protect the owner from any debts or liabilities. A limited partnership, corporation, and LLC protect the owners from debt and liability, to different degrees depending on the form. The four forms file taxes differently, and have different reporting requirements.



Corporation

A corporation is a business entity that is completely separate from its owner. The owner are issued shares that they may sell to end their ownership of the corporation.

Types of corporations

- **C corp** is most commonly referred to as a "corporation." It taxes profits of the company.
- **S corp** allows some profits to pass through to the owners without being double-taxed at corporate rates.
- **B corp** is treated the same as a C corp for taxation, but has to produce "a public benefit" along with any profits.
- **Close corporation** is less structured version of a B corp that may not have a board of directors.

NEED TO KNOW

- **Members** People or institutions (such as pension funds and insurance firms) that own shares in a company; directors may own shares but are not required to do so; also known as subscribers
- **Doing business as (DBA)** Operational rather than registered company name
- **Professional corporation (PC)** Corporate form used in the US and suitable for doctors, lawyers, and similar professional service providers

Limiting liability

Companies structured to limit liability come in various forms, but all operate as entities that are legally and financially independent from their owners.

NAMING CONVENTIONS

The names given to different types of business entities differ from country to country. In the US, a corporation ends with Corp. or Inc. (short for Corporation or Incorporated) and an LLC ends with LLC. In the UK, a corporation ends with Ltd or Plc. In Canada, a corporation ends with Inc, Corp, or Ltd.

LLC

An LLC is a hybrid format that protects the owner from personal liability and from debts, but allows profits and losses to be passed through directly to the owners without being taxed at a corporate rate.

35% of small businesses in the US are LLCs. 52% are some type of corporation.

Quirks of LLCs

- No shares issued, so owners are not shareholders
- Profits are taxed at a lower rate than corporations
- Rules may vary by state, unlike corporations
- When an owner leaves, the entire LLC may be dissolved and have to be redrawn

Private and public companies

While the owner-shareholders of a private company may buy and sell their shares privately (usually with director approval), any investor in the financial market can trade the shares of a public company.

How it works

Although most of the world's companies are set up as private, public companies are seen as more prestigious and profitable. For business ventures requiring large amounts of capital, a public company offers greater opportunity for raising funds because shares can be sold to public investors to generate cash. Private companies must rely on private investors or use the capital investment of their owners. Public companies are subject to more stringent legal controls than private ones and are expected to disclose financial details.

27 million

the number of companies in the US, fewer than 1% of which are public

FAMOUS PRIVATE COMPANIES

- **Mars** Confectionery and pet food; third-largest private US company
- **Aldi** German supermarket chain comprising two private firms, Aldi Süd and Aldi Nord, trading under one name
- **The LEGO Group** Danish company producing household-name toy bricks
- **Hearst Corporation** Mass-media multinational based in New York City
- **IKEA** Swedish retailer registered in Netherlands selling flatpack furniture
- **PwC** Professional services network

Differences between private and public companies

Private company directors have to consider the potential capital increase of joining the stock exchange against the legal red tape aimed at protecting public shareholders.

Private

Directors

Usually control all the shares.

Reporting

In the UK, it is mandatory to file accounts at Companies House; no disclosure is required outside the company in the US.

Shareholders and management

Shareholders are often actively involved in management, so decisions can be made quickly.

Financing

Company must rely on private investment, which is often harder to attract because there are fewer financial details available.

Valuation

Value of the company is more likely to fluctuate; it is more difficult to assess because there are fewer available financial details.

Size

Number of shareholders is limited, usually to fewer than 2,000.

3,800 companies are listed on the Tokyo Stock Exchange.

Directors

Not necessarily shareholders.

Reporting

Company has legal obligation to disclose accounts and submit regular financial reports.

Shareholders and management

Clear boundary is drawn between the role of shareholders and management; there may be conflicts of interest between them. Freely transferable shares mean that original owners could lose control if major shareholders launch a hostile takeover bid.

Financing

Company can tap financial markets to raise capital by selling stock or bonds.

Valuation

Value of the company is easier to assess, from the trading price of shares and financial statements.

Size

Number of shareholders is unlimited.

GOING PUBLIC

There are legal requirements at each stage of converting a company from private to public, including voting in the board of directors and deciding on a new name.

Choose board members

Usually at least three directors to allow future board decisions to be made with only two members present (representing a majority)

Inform staff

Must notify in writing anyone with an interest (including employees and proposed board members) that company intends to go public

Vote for conversion

Board meeting held to vote in favor of changing company's Articles of Association (specifying private or public company)

Register company

Documents setting out board resolutions sent to company registry, which issues certificate declaring the company is public

Make public announcement

Press releases issued, events for business held, and emails sent to inform contacts of change

NEED TO KNOW

- **Unquoted/unlisted company** Another term for a private company
- **Initial public offering (IPO)** Stock-market launch
- **Secondary stock offering** Second-round sale of shares to raise more capital
- **Ticker symbols** Unique codes assigned to publicly traded companies and used by stock exchanges

Multinationals

A multinational corporation has business operations in more than one country. It usually starts as a national company and sets up subsidiary (branch) companies abroad for production and sales.

How it works

Multinationals have several goals: to increase revenue by finding new markets, to streamline operations and production by taking advantage of global locations with lower labor and/or transport costs, and to adapt to local cultural/market differences. A company may achieve such goals by outsourcing (using external suppliers) or offshoring (relocating functions). Companies may also insource (move operations in-house) to rightsource (find a good balance).

Case study: mapping a multinational

Sportswear company Nike has successfully spread around the globe from its corporate base in the U.S. It has manufacturing functions where technical expertise maximizes efficiency and keeps costs down, distribution hubs in strategic locations, and marketing and retail departments in countries where it is establishing local markets.

United Kingdom

London

One of many country HQs in major European cities, the London office serves the U.K. market.

Regional HQ Management and core admin functions

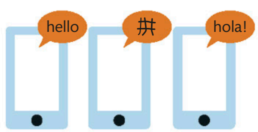
Marketing U.K. campaigns and merchandising

GLOBAL VS. MULTINATIONAL

A global company has facilities in different countries but operates as a single corporate culture with common processes. A multinational has facilities in different countries, but each functions as its own entity, adapting locally, with little communication between geographic divisions.

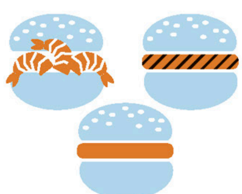
Global

Apple is an example of a global company—the product is essentially the same except for a language change.



Multinational

McDonald's is a multinational—the product changes to suit the market. For example, it serves a shrimp burger in Japan and chicken rice porridge in Malaysia.



United States

Beaverton, Oregon

Senior management are located at the company's corporate base, or "campus," its center for decision making on global strategy, design, marketing, and core functions. Facilities of Nike subsidiary Air Manufacturing Innovation (AMI), which develops and supplies materials, are here as well as in St. Charles, Missouri.

Regional HQ Operations for Americas, Asia-Pacific, and U.S.

World HQ Management, finance, legal, IT, and admin

Global marketing Branding and marketing

R and D Sports research lab and design facilities

Supplier Subsidiary AMI develops and supplies materials

Memphis, Tennessee

Distribution Four high-tech centers in location with good links. Other centers in Indianapolis, Indiana, and Dayton, Tennessee

The Netherlands
Hilversum

Based in a central location, a European headquarters supports operations across Europe, the Middle East, and Africa and is close to the company's European distribution hub in Belgium.

European HQ Management, finance, legal, IT, and admin

Distribution European logistics center based in Laakdal, Belgium

NEED TO KNOW

- **Transnational corporation** Similar to a multinational but does not identify itself with any particular parent nation
- **Platform corporation** Multinationals that do not manufacture but outsource products they have designed

China
Shanghai

The company's fastest-growing market, China is also a manufacturing and distribution base due to local expertise and low production costs.

Chinese HQ Operations and core support functions

Manufacturing Sportswear factories and innovation hubs

Marketing Campaigns for the Chinese market

Distribution Centers in Taicang and Suzhou

Japan & South Korea
Tomisato & Incheon

Major company-owned distribution centers

Distribution Hubs for retail stores across Asia

Vietnam
Dong Nai province

Home to facilities of Nike's AMI subsidiary, which supplies materials. Most manufacturing is carried out by contract factories in Vietnam and Cambodia, benefiting from expertise and lower wages.

Supplier Subsidiary AMI supplies materials to factories

Manufacturing Sites in several countries

Rest of the world
Multiple locations

Nike runs international branch offices and subsidiaries in around 50 countries as well as 1,000 retail stores and 45 digital commerce platforms across the globe.

Regional HQ Core operations and marketing

Retail Online sales and stores around the world

Franchises

A franchise is a business model in which an independent entity—the franchisee—is entitled to set up a branch of an established brand. There are advantages for both parties.

How it works

Rather than developing an original business idea, the franchisee pays for the right to represent an existing, successful brand in a particular location. The size of a franchise can vary from a single unit—one outlet only—to an area development in which the franchisee takes on the option to represent the brand through several branches in a city or region. The franchisor can develop the business with modest capital outlay, while the franchisee takes on a proven business model and brand name, so everyone reaps the benefits.

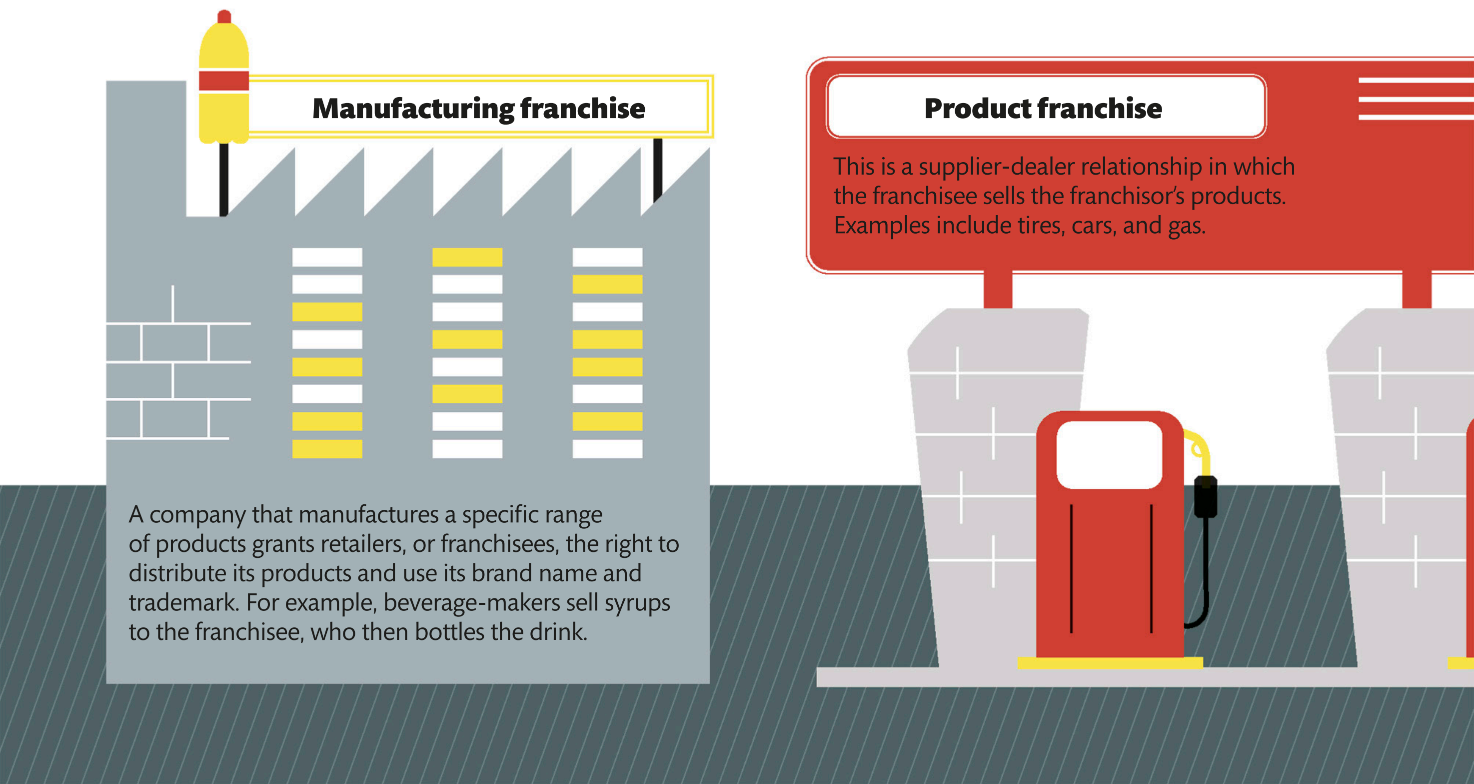
> "I put the hamburger on the assembly line."
>
> Ray Kroc, founder of McDonald's

NEED TO KNOW

- **Franchise disclosure documents (FDD)** Pre-agreement information
- **Microfranchising** Support and training for small-scale businesses in the developing world
- **International Franchise Association (IFA)** Oldest and largest franchise organization

Three types of franchise

The franchisor's level of control varies from managing the contracts for the entire supply chain to input on every detail down to the last French fry. In a product franchise, the franchisor lends its trademark and brand but not an entire business system.



Manufacturing franchise

A company that manufactures a specific range of products grants retailers, or franchisees, the right to distribute its products and use its brand name and trademark. For example, beverage-makers sell syrups to the franchisee, who then bottles the drink.

Product franchise

This is a supplier-dealer relationship in which the franchisee sells the franchisor's products. Examples include tires, cars, and gas.

TOP 10

Fastest-growing franchises worldwide

1. **Century 21 Real Estate** property
2. **KFC** fast-food outlets
3. **Circle K** convenience stores
4. **Jan-Pro** commercial cleaning
5. **McDonald's** fast-food outlets
6. **Taco Bell** fast-food outlets
7. **7-Eleven** convenience stores
8. **F45 Training** fitness
9. **Stratus Building Solutions** commercial cleaning
10. **Anytime Fitness** gyms

CASE STUDY

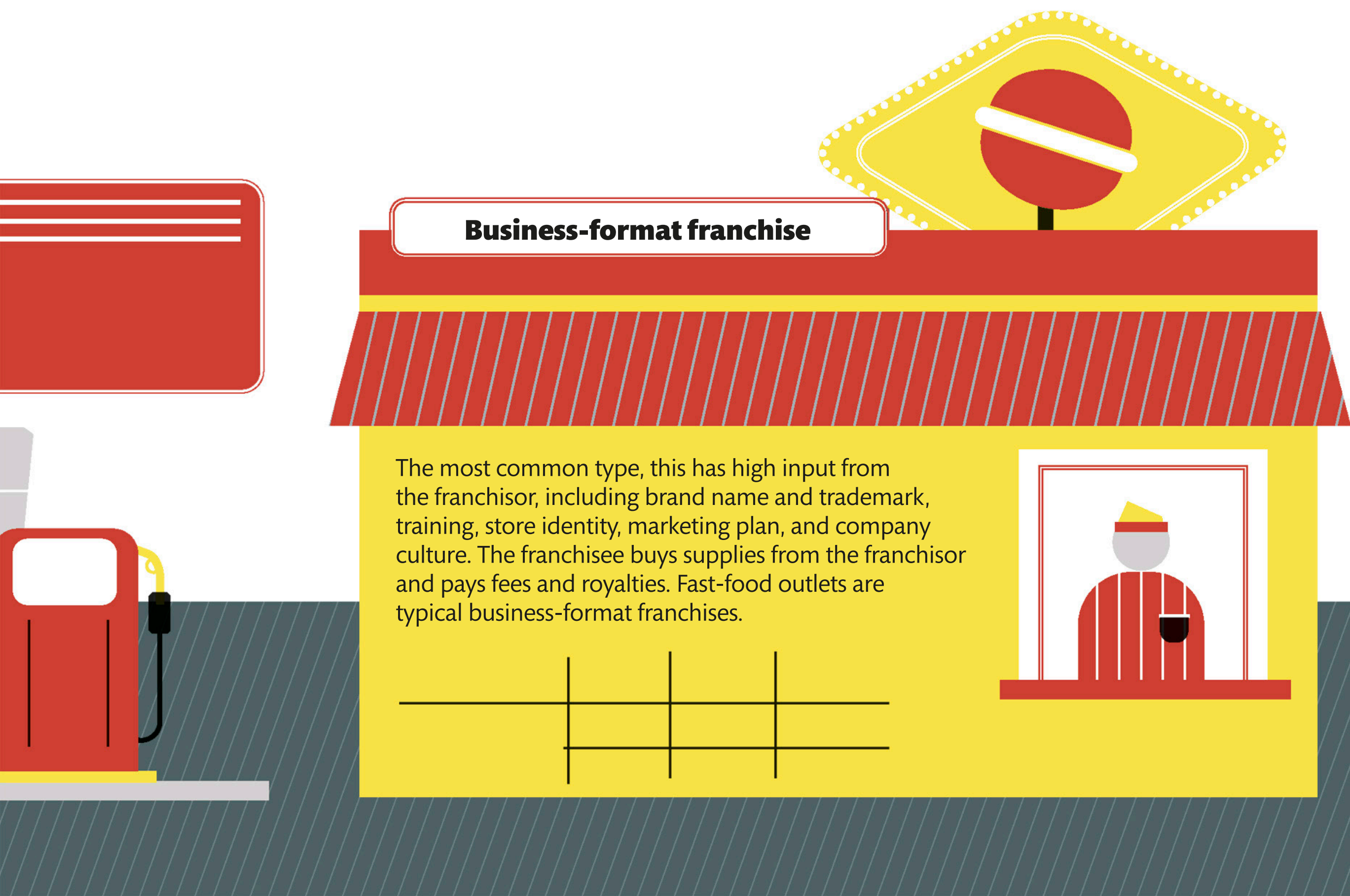
Business-format franchise: fast-food outlets

The business-format franchise, in which a franchisee takes on a whole blueprint for running the business as well as the product itself, was pioneered in the US in the 1940s.

Fast-food outlets were a new concept at the time and were generating great demand. To increase the rate of expansion, these original fast-food entrepreneurs developed a franchise system under which the franchisee was contractually required to run the outlet according to strict guidelines.

A limited and uniform menu was the key to the success of these franchises. The consistency of the menu, service, and surroundings helped establish a strong brand identity because customers were assured that the product and experience would be the same anywhere in the country.

McDonald's is one of the most successful examples, collecting a 4 percent service fee and rent from its 36,000 franchises worldwide.



Not-for-profits

Some organizations are run not for the benefit of shareholders but for the benefit of their members or an external community or charity. Unlike conventional businesses, profit is not the goal.

How it works

Organizations that do not intend to generate profit for their shareholders, are self-governing, and are committed to a common cause are categorized as not-primarily-for-profit, not-for-profit, and nonprofit entities. On this spectrum, cooperatives may disburse profits to members, but charities are strictly nonprofit. Although their goals differ, not-for-profits have a similar type of company status and structure as businesses.

8.6% of all wages and salaries paid in the US come from the not-for-profit sector.

The not-for-profit universe

There are many forms of not-for-profit organization (NPO). Joel L. Fleishman, professor of public policy and law at Duke University, has characterized the not-for-profit sector as a universe that embraces all NPOs, whatever their mission.

Cooperative
Owned by members; can benefit from profit; clear ethos of pursuing common economic, social, or cultural goals; one member, one vote

Private foundation
Similar to a charity but funded by one source, as opposed to the general public; generates revenue from investments; makes grants to other charitable bodies

Social organization
Based on common interests or beliefs, such as social or academic interest or a benevolent cause; civic clubs and college fraternities/sororities are examples

THRIVING SECTOR

Despite being NPOs, many cooperatives and mutuals have a sizeable annual turnover (gross revenue transacted).

- **France** Crédit Agricole Group of cooperatives and mutuals: $89 billion
- **Germany** REWE Group: $63 billion
- **Japan** Zen-Noh cooperative: $56 billion
- **US** State Farm mutual: $43 billion
- **Korea** Nonghyup (NACF): $41 billion
- **UK** Co-operative Group: $14 billion
- **Spain** Mondragón cooperative: $14 billion

NEED TO KNOW

- **Philanthropic sector** Alternative umbrella term for the not-for-profit sector or universe
- **Charity Navigator** An organization that monitors and publishes information about charities to help consumers decide which charities to support
- **501 c3** Tax code designation that indicates that an organization is legally a tax-exempt charity
- **Associated charity** Organization related to a main charity that takes on a particular aspect of the charity's work

NOT-FOR-PROFIT STRUCTURE

Chair coordinates the work of the directors.

Board of directors is usually unpaid; may also be called the board of trustees.

Committees formed by board members carry out specific tasks, such as fundraising.

Administration staff often includes a proportion of volunteers.

Nongovernmental organization (NGO)
Funded by government or by international donor agencies, such as the World Health Organization (WHO); operates independently

Mutual
Raises funds from its members (usually customers); often takes the form of financial institutions; profits reinvested in the mutual or to sustain or grow the organization

Chamber of commerce
Group of business people that gathers to promote trade, investment, and cooperation; usually funded by subscriptions from local businesses

Social enterprise
May sell goods or services to fund community projects; any surplus revenue is reinvested in the enterprise for the community

Charity
Must be registered as charity status; tax exempt; all resources must be devoted to the charity's stated charitable activities; may be organized as a trust, corporation, or association

Start-ups

A start-up is a new business in the early stages of development and operation, during which an entrepreneur or founding group comes up with an idea for a product or service, researches it, develops a business plan, raises funds, and launches. Registering intellectual property (IP)—a unique creation, not just an idea—in order to protect it is an important stage of the start-up process. Protection includes trademarks, patents, and copyright.

The early days

Before a company is fully developed with a working business model, it is known as a start-up. The start-up evolves from an entrepreneur, or group of entrepreneurs, with an idea or invention. It can take a few years to turn the initial concept or prototype into a viable, profitable venture, so the start-up founder tries to attract support and financial backing to achieve rapid growth. During this phase, which can take anywhere from a few months to several years, the business changes quickly.

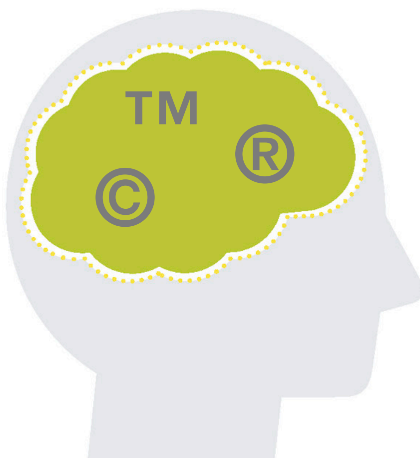
4.35 million new business applications were submitted in 2020 in the US.

NEED TO KNOW

- **Internal start-ups** Start-ups that originate from inside a large organization
- **Patent trolls** Individuals or companies who buy the patents of failed start-ups and attempt to collect licensing fees from potential infringers of the patents

INTELLECTUAL PROPERTY (IP) VALUE

The term "start-up" became commonplace during the dot.com boom of the late 1990s, when thousands of entrepreneurs with web-based products and services found funding, many on the strength of their intellectual property alone. Giants Google and Amazon both started up at this time. Since then, technology businesses have become one of the most talked-about start-up types. Their value is often based 100 percent on intellectual property.



The big idea

Consider the IP

- Register IP.
- Find a name.
- Buy a domain.
- Research market.

Choose a start-up type

- With a social conscience?
- Primed to grow big?
- To fit lifestyle?

See pp.30–31.

Make a business plan

- Explain how the business will make money.
- Describe the unique aspects of the business.
- Determine how much money the business will need and will make.

See pp.32–33.

Seek help

- Join a business accelerator.
- Enter a business incubator.
- Go it alone.
- Find an investor.

See pp.38–39.

Find funding

- Invest savings.
- Ask friends and family.
- Take out a bank loan.
- Seek venture capital.
- Try crowdfunding.

See pp.34–37.

Prepare to launch

- Plan a marketing campaign.
- Run a test launch and refine message and offer.

See pp.196–197.

Launch

- Win? Lose?
- Research indicates that, in most Western countries, 80–90 percent of start-ups fail.

49.6% of adults in Angola are starting or running a new business.

Start-ups, from concept to launch

A new business can be described as a start-up in the early phases of its launch, when an entrepreneur comes up with the idea for a product or service and develops it into something that will sell.

How it works

The idea is just the start. Next comes the process of expanding the concept into a viable business. Specialized help may be needed in some areas—a digital marketing advisor or an accountant to advise on the best structure and financial set-up, for example. What the business and product or service are called can make or break the start-up, so it is worth spending some time doing online research to check that no one else is using a desired name, especially in a negative context. Location is another consideration—it may be possible to create a virtual office and work from home. Finding offices is an extra stage, but the aim at start-up is to keep costs low.

NEED TO KNOW

- **Lean start-up** Method of learning fast and discarding what does not work to keep start-up costs down
- **Start-up pivot** Quickly changing direction or correcting mistakes based on customer feedback or technology changes

START

Come up with a good idea
Develop a product or an idea for a product or service.

Register IP
For an invention or innovation, register intellectual property (IP) with copyright, trademark, or patent.

Decide on a name
Check to determine whether your proposed name is available; check that the domain name is available; search online for competitors with similar names.

Set up an online presence
Register the domain name and set up web hosting.

Create a look
Design a logo and visual brand for the business.

Make a website
Build a website. Research search engine optimization (SEO) words to include (*see pp.230–231*).

CASE STUDY

Om Engineering Works

Om Engineering Works was started in 1987 by Om Prakash Jaiswal. Operating from a shop in Uttar Pradesh, in northern India, he used to sell rubber containers and plates to battery companies, but in 2000, he came up with the idea of producing the batteries himself, and later, with the idea of smelting and recycling them.

Since then, the market for these batteries has grown, and breakthroughs in manufacturing technology have allowed the firm to go from making 20 to 300 batteries a day.

Now known as Highflow Industries and run by Om Prakash Jaiswal's son, Sumit Jaiswal, the company makes batteries for e-rickshaws, solar panels, inverters, cars, tractors, two-wheeled vehicles, and more.

"There is a huge market potential with the advent of solar and e-rickshaw segments," says Sumit Jaiswal. "This is because they help cut down air pollution and reduce overall carbon emissions. The batteries have always played a vital role in this."

8% of start-ups go on to become successful businesses.

Research market
Study your proposed target market and potential competitors and evaluate the viability of the idea.

Decide structure
Choose a business structure that suits your initial needs but also allows flexibility for growth.

Devise a plan
Draw up a plan (*see pp.32–33*), including your goals, mission statement, and key financial information.

Obtain backing funds
Consider a business incubator *(pp.38–39)* if the business requires large-scale support.

Set up finances
Include an accounting and cash-flow system, sales tax if applicable, and bank account.

Start marketing
Plan a marketing campaign. Run a test and make any refinements to the message or strategy.

LAUNCH

Types of start-up

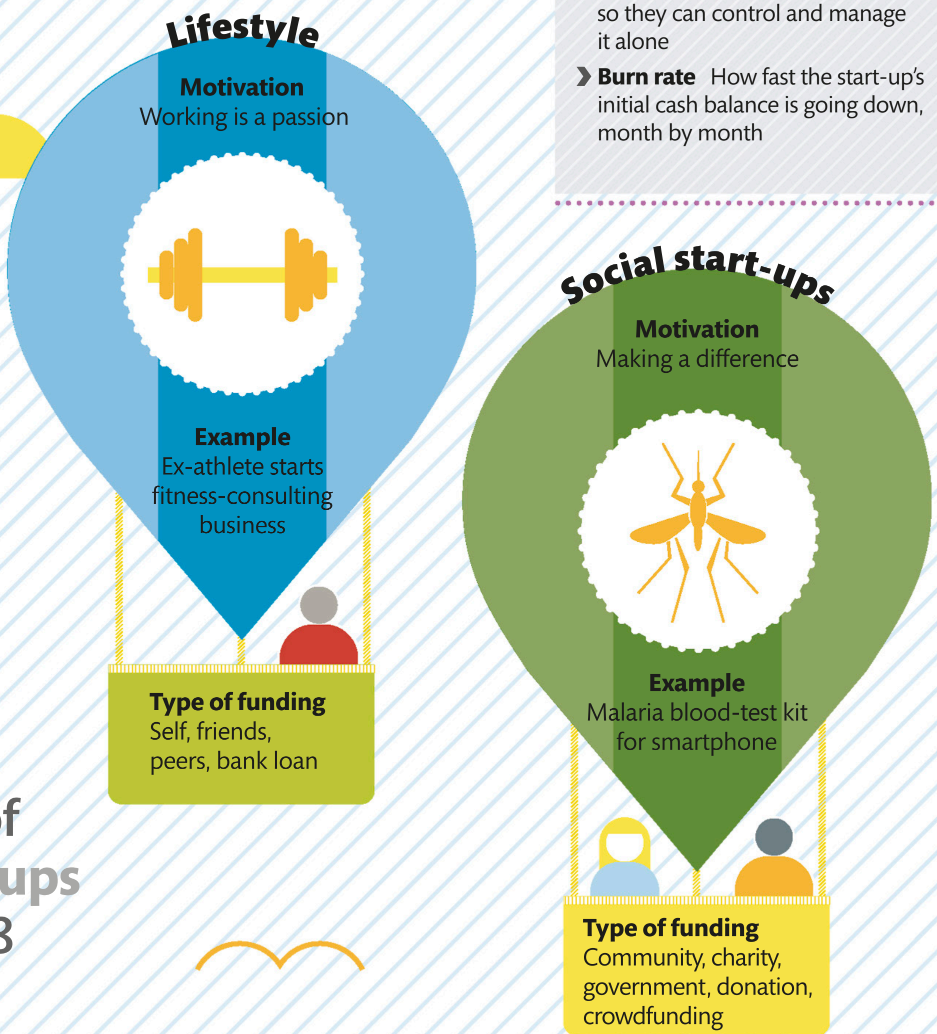
Entrepreneurs go into business for many reasons: some start-up decisions are based on personal convictions; some are founded on the desire to make money, and others are a mix of the two.

How it works

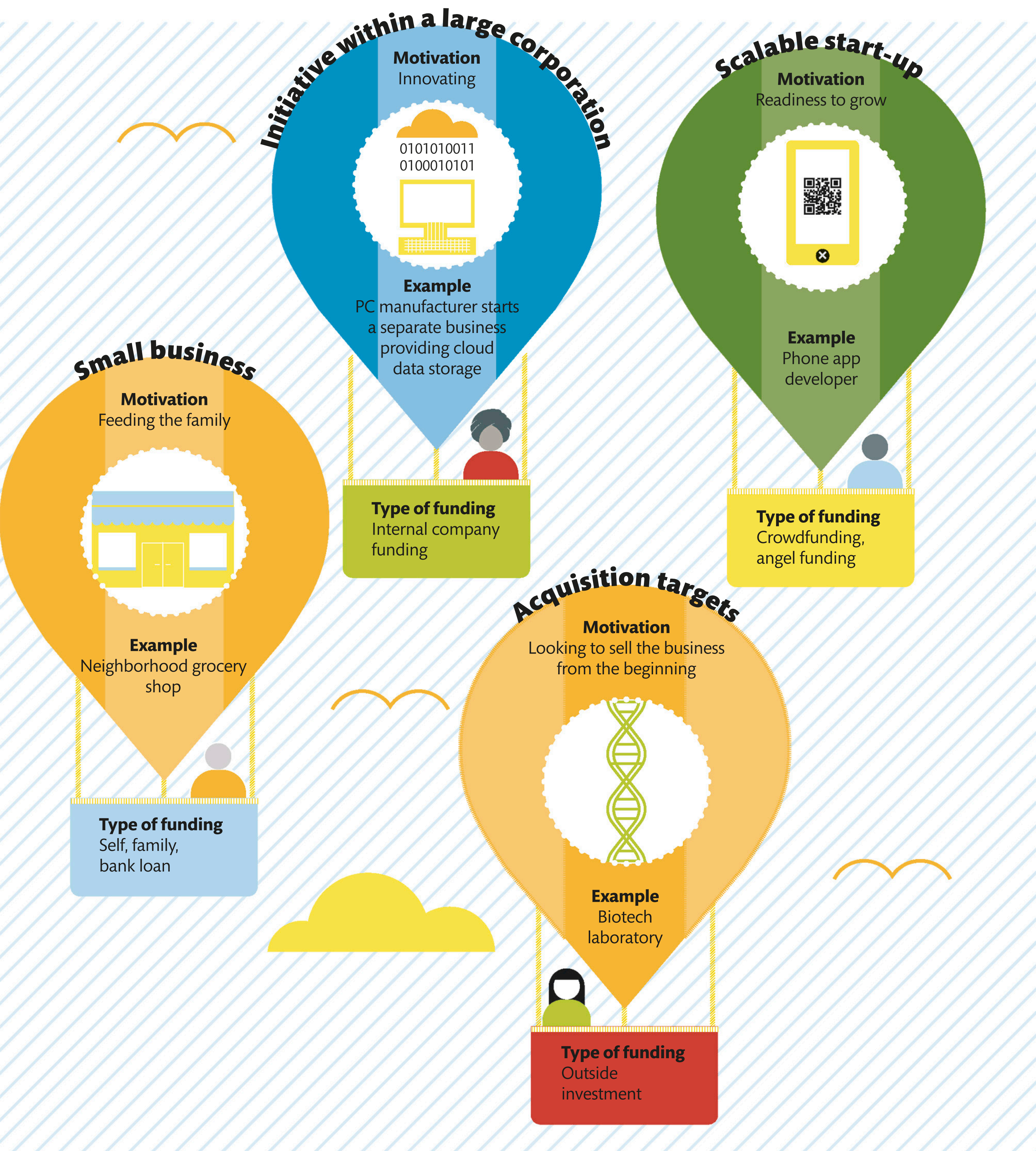
Not all start-ups fit the same mold. Although they often follow a similar process in their initial evolution, they are as varied in type as the personalities behind them. Start-ups can broadly be divided into those that are intended from the outset to be large ventures within a corporate environment and those intended to work on a more personal scale to suit the lives and passions of individuals.

NEED TO KNOW

- **Enterprise portal** Dedicated website providing content for staff, usually intended for larger companies
- **Micropreneur** Entrepreneur who keeps their business small so they can control and manage it alone
- **Burn rate** How fast the start-up's initial cash balance is going down, month by month



72% growth in the number of fintech start-ups between 2018 and 2020


Initiative within a large corporation
Motivation
Innovating
0101010011
0100010101
Example
PC manufacturer starts a separate business providing cloud data storage
Type of funding
Internal company funding
Scalable start-up
Motivation
Readiness to grow
Example
Phone app developer
Type of funding
Crowdfunding, angel funding
Small business
Motivation
Feeding the family
Example
Neighborhood grocery shop
Type of funding
Self, family, bank loan
Acquisition targets
Motivation
Looking to sell the business from the beginning
Example
Biotech laboratory
Type of funding
Outside investment

Business plans

Writing a business plan is one of the most important steps in developing a start-up. The plan provides the new business's goals, market analysis, and projected income and profit.

How it works

Before a start-up entrepreneur can write a business plan, they need to have done enough research to identify a clear opportunity in the market for the product or service and to define how the proposed new business will be uniquely positioned to capture that market, given the services or product being offered. An outline of existing finances and an accurate projection of sales and profit are essential components, especially if the owner is seeking external funding.

Key elements

Preparing a business plan can take several weeks, and it is worth doing thoroughly. It is a vital document for securing funding, so the financial forecast must be both realistic and accurate. If it is being shown to others, pare the executive summary down to two A4 pages, write it in plain language, and explain any technical terms.

69% of current small business owners recommend writing a plan.

Executive summary

Complete this section last, bearing in mind that it may be the only part that a busy person reads:

- **Business summary** Company structure, name, product or service, and customer profile
- **Business aims** Three objectives over one, three, and five years
- **Financial summary** Expected sales, costs, and funding
- **Elevator pitch** Two-minute talk to sell your idea to an investor

Business background

Provide details of each person in the business:

- **Experience** Relevant work carried out to date, achievements, contacts made
- **Qualifications** Credentials, such as diploma in horticulture for a gardening service
- **Training** Past and future, including business skills, such as assertiveness

Products and services

Describe what the business is going to sell:

- **Product or service** With a picture if the product is new
- **Range** If more than one, such as garden design and maintenance
- **How it is different** What makes the product or service stand out from the crowd?

The market

Set out specific details of the potential market:

- **Typical customer** Businesses or individuals and their profile; local, national, or international
- **Market research** What the local market is like for similar products or services

Marketing strategy

Choose about three of these methods:

- **Social media**
- **Website**
- **Word of mouth**
- **Advertising**
- **Business literature**
- **Direct marketing**

TOP FIVE REASONS TO WRITE A PLAN

- **The process** Working through each element ensures nothing is forgotten.
- **Costing** The only way to find out whether the business is viable is to work out details of costs and sales.
- **Funding** A good business plan improves chances of getting a loan.
- **Areas of expertise** Making a business plan clarifies where outside help is needed—for instance, for bookkeeping or marketing.
- **Getting to know the competition** Conducting market research is the best way to give a business an edge.

NEED TO KNOW

- **SWOT analysis** Stands for Strengths, Weaknesses, Opportunities, and Threats
- **Unique selling point (USP)** Feature that makes a product different from competition

Competitor analysis

Show how the business idea compares with the competition:

- **Table of competitors** Who and where they are, what they sell and for how much, how good they are
- **SWOT analysis** Including how to remedy any weaknesses and combat known threats, such as a garden center opening nearby
- **USP** Unique selling point of the product or service

See Need to Know panel, above.

Operations and logistics

Describe how the business will run day to day:

- **Supply and delivery** How the goods or service will get from A to B
- **Equipment** Transportation, office items, and location
- **Payment, legal, and insurance** How customers will pay and how that translates into salaries; compliance with the law

Costs and pricing strategy

Work out how much the product or service costs and its sale price:

- **Cost** How much each unit or batch costs to make and deliver
- **Price** How much each unit or batch will sell for
- **Profit margin** The difference between cost and price per unit

Financial forecasts

Predict sales and costs over the year, allowing for seasonal fluctuation, such as spring demand for garden services:

- **Sales calculations** For each month, the expected number of sales
- **Costs calculations** The costs of the predicted sales each month
- **Cash-flow forecast** The money coming in and out of the business

See How Finance Works, pp.98–175.

Back-up plan

Make a Plan B in case something goes unexpectedly wrong:

- **Short-term changes** Cutting costs or boosting sales immediately
- **Longer-term changes** Shifts, such as working online, not on-site
- **Closure** Lessons learned and skills acquired if the business closes

Raising money

Almost every new enterprise needs funding to get it going and to keep it afloat until it turns a profit. Financial help is available from a variety of sources, suitable at different stages of start-up growth.

How it works

Capital for new enterprises comes from two main sources—lenders and investors. Lenders, such as banks, provide debt capital in the form of a loan that is returned with interest. Investors, such as business angels and venture capitalists (VCs), provide equity capital in the form of a share in the business that includes a proportionate share of control and rewards. Both types of funding can be corporate—from a company—or come from other sources, such as crowdfunding.

Types of start-up funding

Corporate and traditional funding, which tend to be substantial, come largely from banks and VCs, while smaller sums come from individuals instead of institutions.

Lenders

Debt capital most often takes the form of loans paid back with interest.

Term loan Paid back regularly over a set period of time

- **Bank** Offers either personal or business loans
- **Building-and-loan association** Offers loans to buy a property
- **Government** Offers low-interest start-up loans
- **Credit union** Cooperative that offers members low-interest loans
- **Peer-to-peer (P2P) lending** Unsecured personal loans
- **Friends and family** May offer interest-free loans

Bank overdraft or credit card Interest charged monthly if balance not paid in full

- **Bank or credit company** Finance organization that makes loans to commercial ventures

Factoring/invoice discounting Unpaid invoices sold at a discount to a company that collects them for commission

- **Factor or discounter** Company that offers advances on unpaid invoices, for a profit

NEED TO KNOW

- **P2P lending** Loans made between individuals over Internet
- **Crowdfunding** Debt or equity raised via internet platforms

Start-up funding

36% of prospective small business owners say that getting start-up funding is a priority.

Investors

Equity capital is paid to the start-up in return for a share of the business.

Founders, friends, family (FFF) May buy shares in the company rather than lending money

Crowdfunding Large number of supporters, each contributing a small amount of money, usually online

Angel investors Investors who give favorable terms, as their focus is on the company's success rather than on profit

Venture capitalists (VCs) Companies that provide capital for new businesses in the hope of reaping profit

Grants

Financial awards and prizes are provided by public bodies.

Local, national, global Funded by a local, state, or federal government initiatives, an agency, or a charity

TYPES OF CROWDFUNDING

Crowdfunding is becoming a more acceptable source of alternative funding. There are four main types:

- **Equity-based** The company sells shares to raise capital. In return, investor owns part of the business.
- **Debt-based** Where individuals lend money to the company. In return, the company agrees to pay it back at given intervals, with or without interest.
- **Royalty-based** Crowdfunders receive a percentage of the company's revenues once it generates returns.
- **Incentive-based** Investors donate money in exchange for free products or merchandise, or other incentives from the business.

Alternative models

In the wake of the economic downturn that started in 2008, several innovative and more personal types of funding, such as crowdfunding and peer-to-peer (P2P) lending, have evolved and blossomed on the Internet. All involve the principle of raising small amounts of money from large numbers of individuals, who pool their resources to provide the loan or equity needed.

CREDIT ANALYSIS CRITERIA FOR LENDING

Capacity

The borrower's ability to repay the loan is shown by the business plan.

Capital

Many lenders assess a borrower's net worth to verify assets versus debts.

Character

The borrower needs to show a good credit history and ability to succeed.

Collateral

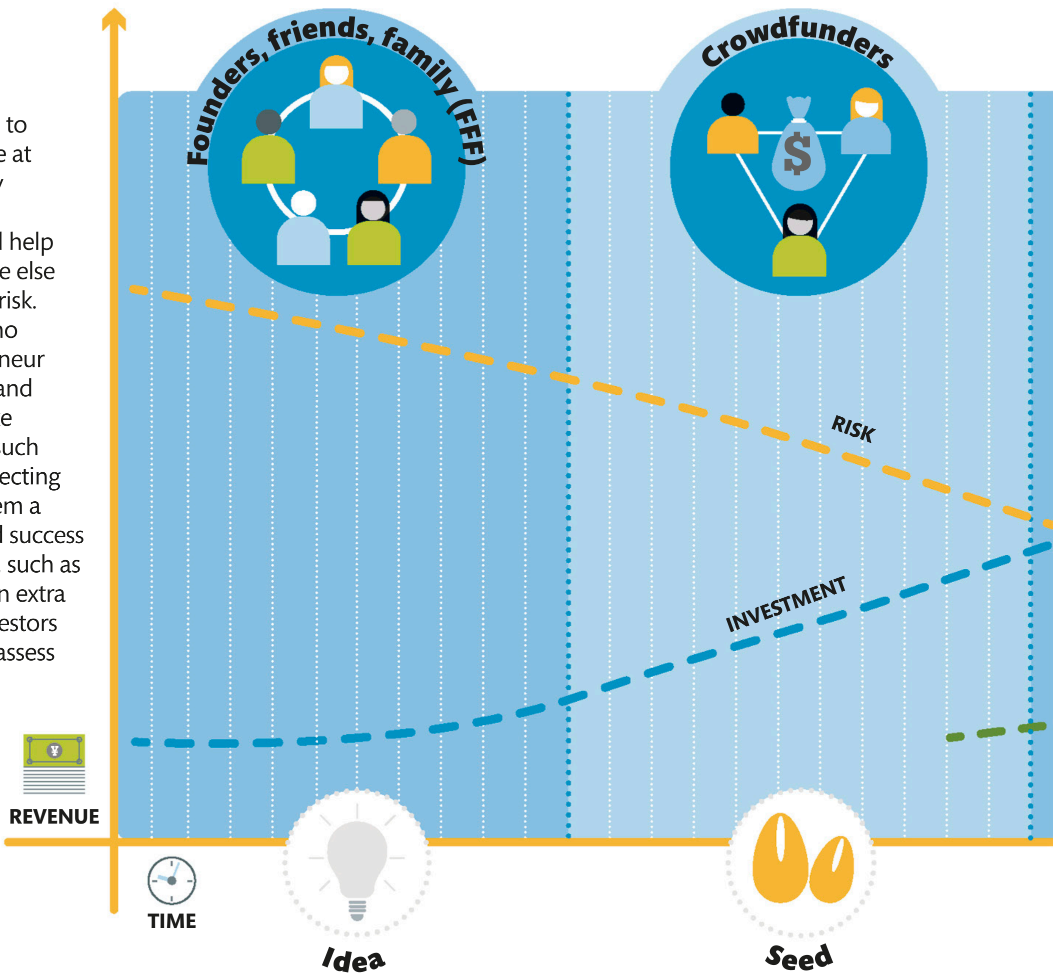
The borrower is often expected to pledge an asset that can be sold to pay off the loan if funds are too low to pay the monthly interest or repay the capital at the end of the term.

Conditions

The lender is swayed by the current economic climate as well as by the sum requested.

Life cycle of investment

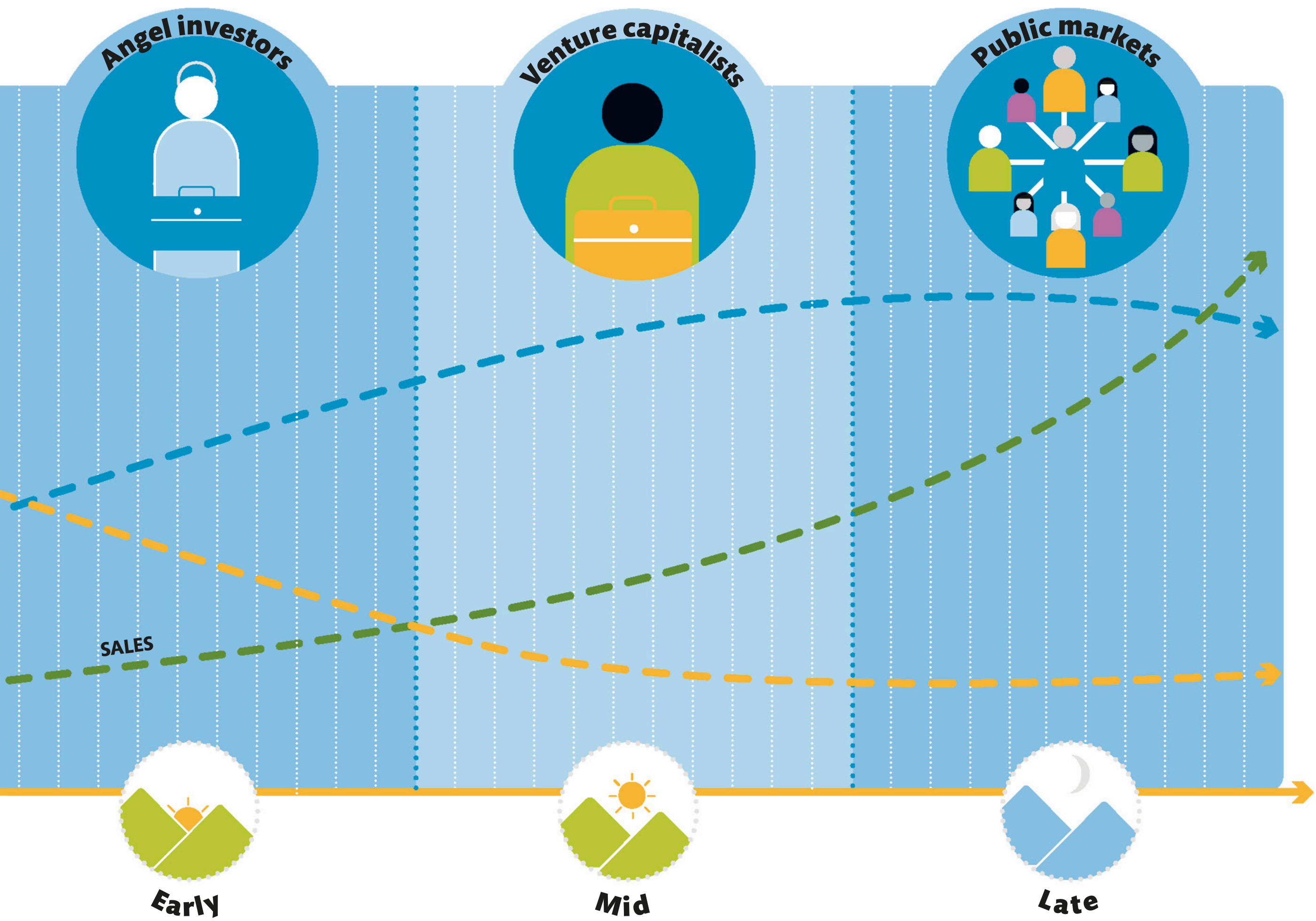
The key to successful funding is to choose the right type of finance at each stage of a company's early growth. Start-ups usually begin modestly, with self-funding and help from friends, family, and anyone else who is prepared to take a high risk. Crowdfunders are amateurs who are willing to help the entrepreneur succeed, while angel investors and venture capitalists will likely take more risks than other lenders, such as banks, if they believe that injecting substantial funds will return them a healthy profit. As sales soar and success looks probable, public markets, such as stock exchanges, can provide an extra funding boost. At all stages, investors will conduct credit analyses to assess a firm's ability to repay its debt.



Financing 5,000 startups over the last decade

The chart shows sources of start-up finances from over 5,000 entrepreneurs in the US from 2005 to 2015, taken from a 2015 survey by the Kaufman Foundation. By far, the most funding comes from bank loans and individual savings.

30% Personal savings	6.2% Credit card
34.9% Bank or other loan	18.5% Other



Business accelerators and incubators

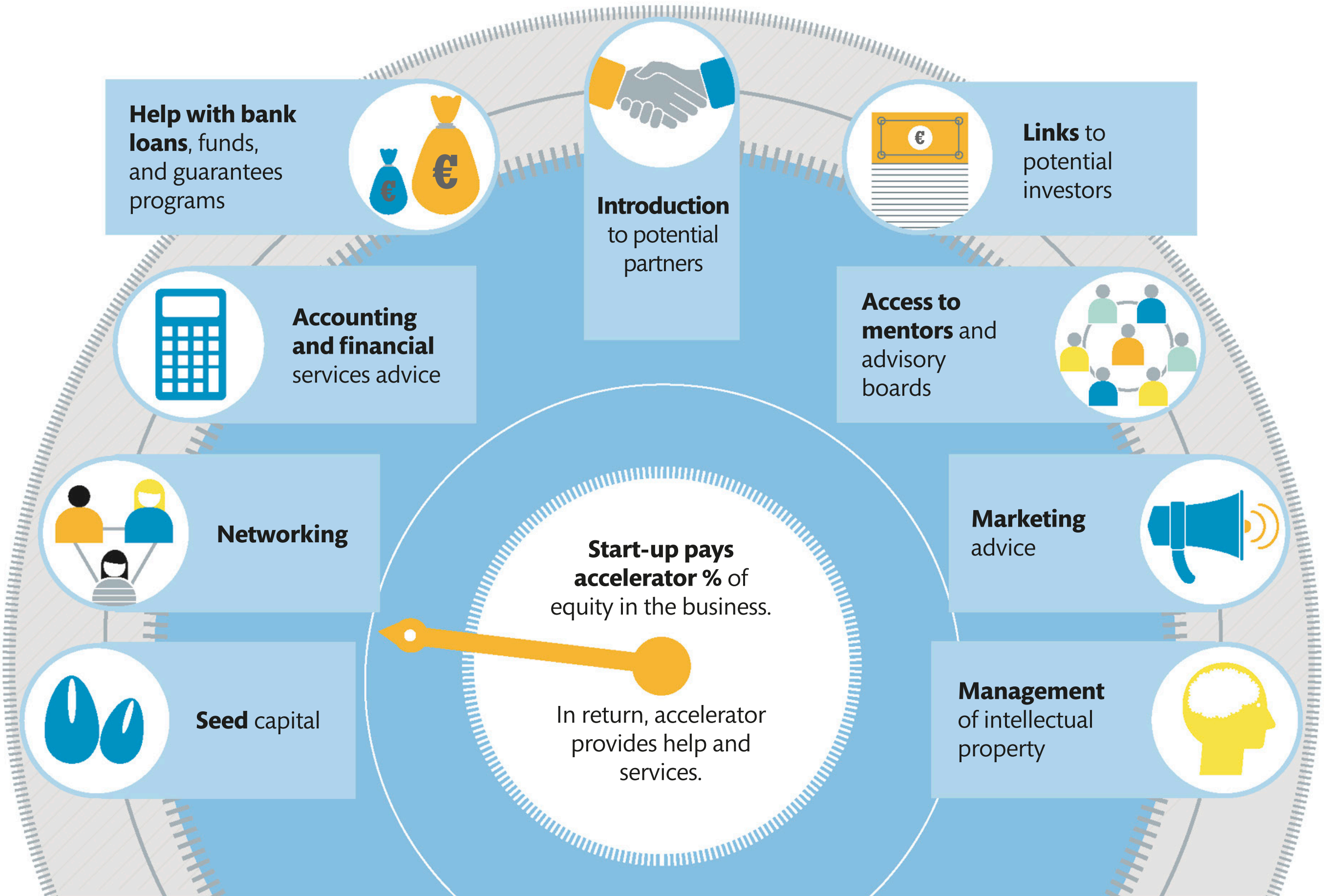
Starting a new venture can be a long process. Business (also called venture) accelerators and incubators are specialist organizations devoted to developing and supporting start-ups.

How it works

Business accelerators and incubators provide expertise and connections in the formative stages of a business in return for a percentage of ownership. They are two separate types of service. Business accelerators are short-term programs that offer wide-ranging support, including mentorship, business advice, and connections to potential sources of finance. Business incubators, on the other hand, provide a supportive environment in which fledgling start-ups can develop, offering technical assistance, working space, and networking opportunities.

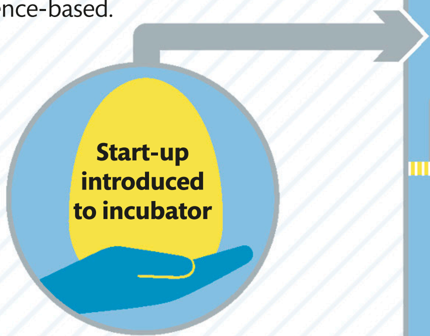
Business accelerators

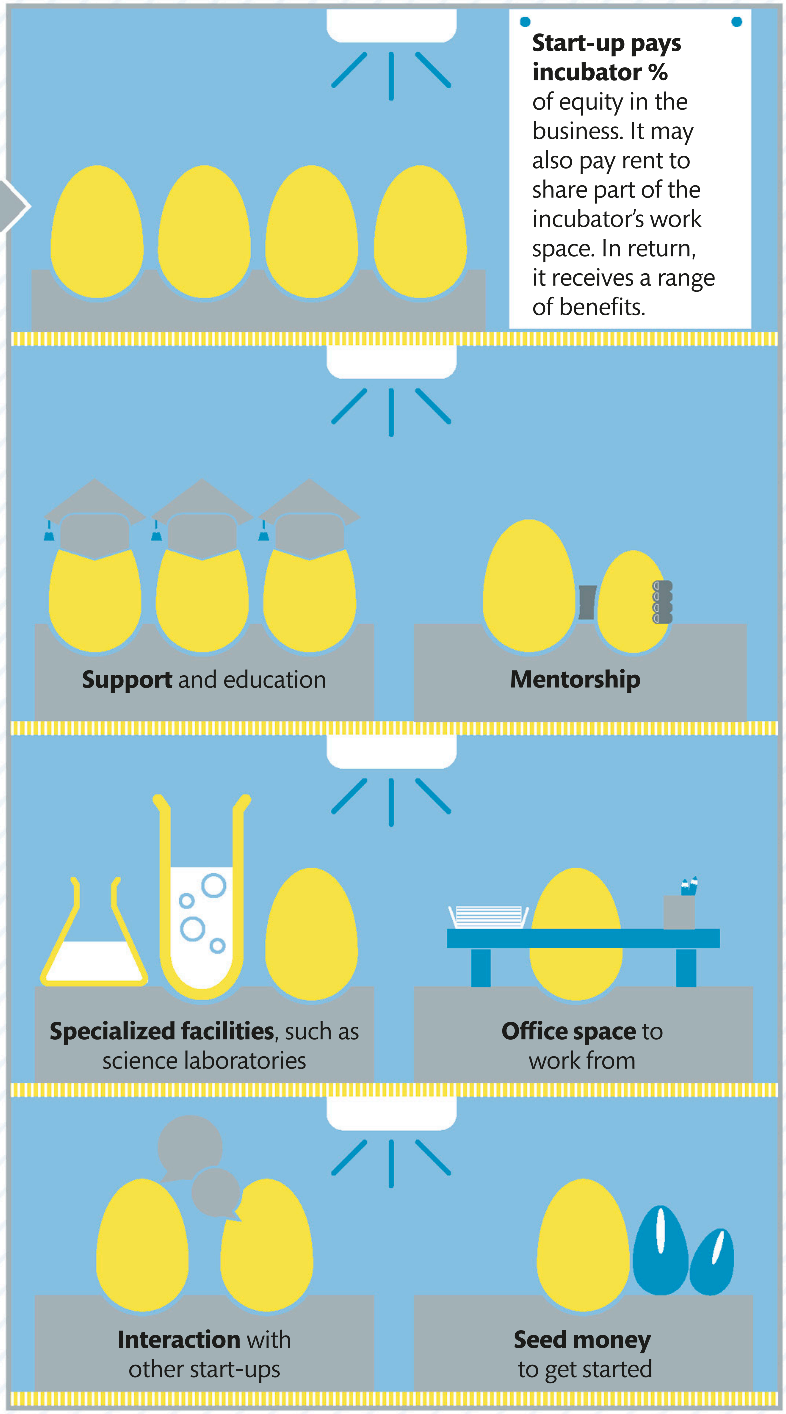
Suited to start-ups that have limited financing, accelerators offer short-term (one to three months) boot camps. Individual accelerators may specialize in a specific area, such as software development.



Business incubators

Often sponsored by nonprofit organizations, incubators tend to be longer term (one to five years) and cater to a variety of clients, many science-based.





NEED TO KNOW

- **Incubator networks** Collaboration of incubation centers, research facilities, and science parks
- **Virtual business incubator** Online hothouse for start-ups

$107 million invested globally by US and Canadian accelerators from 2012 to 2017.

Buying & selling businesses

Both private and public companies regularly change hands—they are bought, sold, and restructured to reflect changing business conditions. These deals all come under the umbrella term of mergers and acquisitions (M and A). Acquisition financing is usually needed to pay for the purchase of another company, often in the form of a loan or venture capital.

How to acquire a company

A company is typically acquired in one of two ways—either by a management team or by another company. When a company is buying, the result can be a merger, in which two companies join forces; an acquisition, or an outright purchase; or a demerger, in which part of a company is broken off and may be sold. Management team purchases are often funded by private equity.

Mangement team acquiring

Private equity firms look for companies to buy and then sell their shares when profits have maximized. They fund the management team. *See pp.48–49.*

Buy-out

The existing management team buys out the company that they work for.

Buy-in

An external management team buys into the company.

Demerger

Part of a company is split off to form a new company; may become acquisition target. *See pp.44–45.*

45,652

the number of M and A deals, globally, in 2020

Another company acquiring

Companies may want to expand by joining up with another business.

Merger

The company combines with another company. *See pp.42–43.*

Acquisition

Horizontal The company buys another company that makes similar products or offers similiar services.

Vertical The company buys another company that makes different products or offers different services. *See pp.46–47.*

M AND A KNOW-HOW

Measuring a big deal

The corporate world categorizes acquisition deals according to the capitalization size (the value of the company's shares).

Small Under $500 million

Mid-market $500 million to $2 billion

Large $2 billion to $10 billion

Megadeal More than $10 billion

Due diligence

Before any company sale, the potential buyers see a detailed report prepared by lawyers, covering key aspects of the target business.

- **Financial** Identifies problem areas that could affect the future value of the company.
- **Legal** Gauges possible legal risks attached to corporate status, assets, securities, intellectual property, and employee restructuring.
- **Commercial** Includes industry trends, market environment, the company's capabilities, and the competition.
- **Environmental** Uncovers potential liabilities, such as land or water contamination, and estimates remedial cost.

Mergers and acquisitions

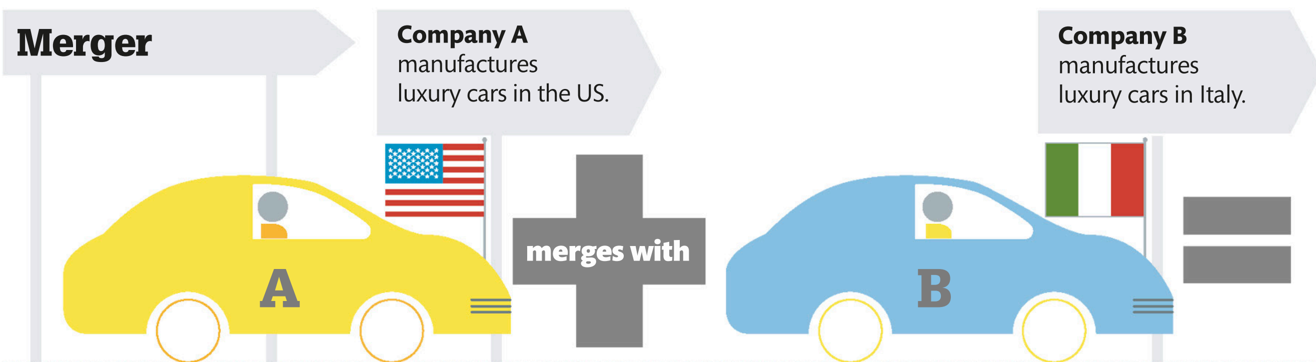
Two of the quickest ways to accelerate expansion are for a business to buy out another—an acquisition—or to combine with another business in a merger.

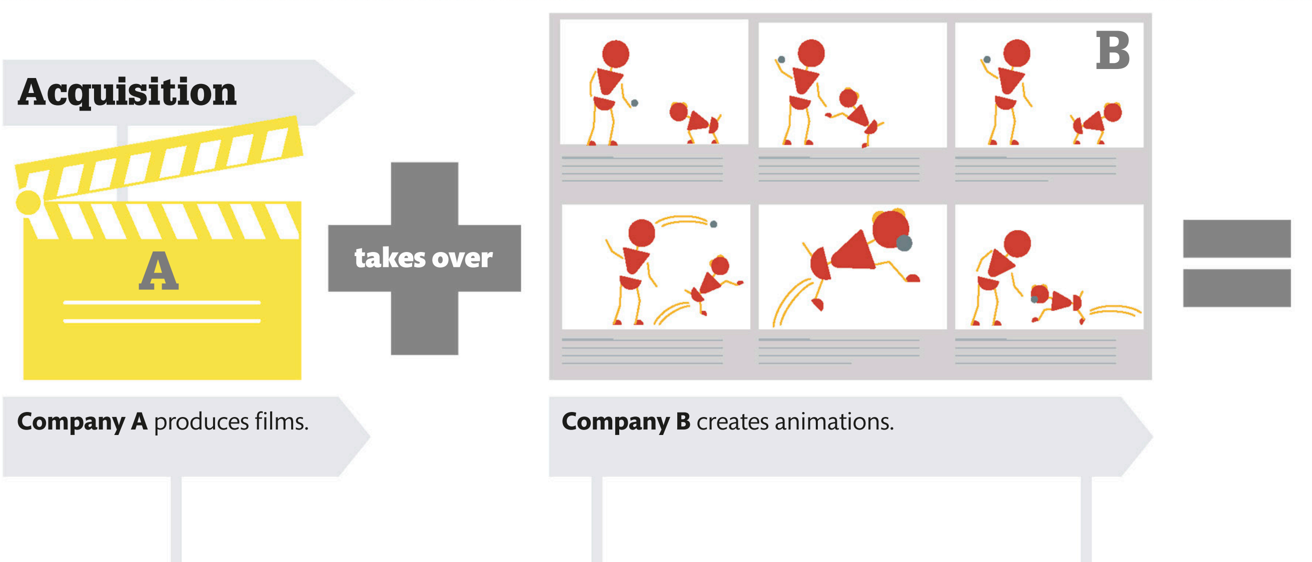
How it works

"Mergers and acquisitions" (M and A) is a general term used to describe the ways in which companies are bought, sold, and recombined. In the case of either a merger or an acquisition, two separate legal entities are unified into a single legal entity. While a merger combines two companies on reasonably equal footing to create a new company, which will benefit both parties, an acquisition is usually a purchase of a smaller company by a larger one. This benefits the company making the purchase but may not necessarily benefit the target company. M and A can be friendly or hostile, agreed to or imposed.

REASONS TO PURSUE M AND A

- **Improved economies of scale** Wider operations streamline production and sales.
- **Bigger market share** Combining the existing markets expands share of the total market.
- **Diversification** A different product lineup gives the chance to cross-sell or create more efficient operations if the products are complementary.





FRIENDLY VS. HOSTILE

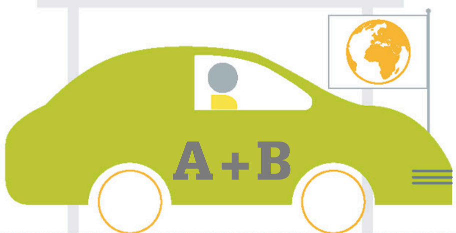
- The target company's board of directors and management agree to be bought out.
- The acquiring company makes an offer of cash or stock to the target company's board and management.
- The stock or cash offer is set at a premium level.
- Because the offer is above actual market level, shareholders usually agree to it.

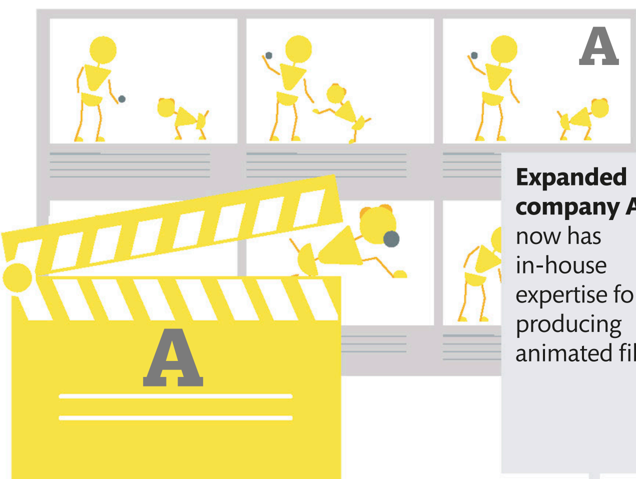
- The acquiring company bypasses management and goes straight to the target company's shareholders.
- The target company's management fights the deal.
- The buying company convinces shareholders to vote out the management (a proxy fight), *or* it makes an offer to shareholders to buy shares at an above-market price (a tender offer).

NEED TO KNOW

- **Pacman strategy** The target company tries to take over the very company attempting the hostile buyout
- **Swap ratio** An exchange rate between the value of the shares of two companies when merging
- **Defensive merger** Undertaken to anticipate a merger or takeover attempt that threatens a company
- **Economies of scale** Benefit to a company of M and A expansion

New company A + B now has an expanded market spanning Europe and North America.





Expanded company A now has in-house expertise for producing animated films.

$734 billion the value of all mergers and acquisitions in the Asia-Pacific region in 2020

Demergers

While a merger results in a bigger company, a demerger reduces the size of a business by breaking it down into smaller components or divisions, which are then sold off or dissolved.

How it works

The typical scenario for a demerger is a company that is struggling to pay off debt it has taken on to expand into new areas of business that are not yet profitable. To save the rest of the company from the burden of debt, management decides to start a demerger. Generally, the aim is to shed the least profitable areas of operation or, from the potential buyer's point of view, those that have promise but are not yet profitable. The process of restructuring by demerger is designed to free the company of divisions with low return, to reduce debt and financing requirements, and to give the shareholders a stronger return. The market price of the parent company's shares often bounces back strongly, and its spin-off companies may thrive too.

SUCCESSFUL SPIN-OFFS

Mondelēz The spin-off of Kraft Foods owns the Oreo, Ritz, and Trident brands.

Paypal Formerly part of eBay, the online payments service became a stand-alone firm in 2015.

Tripadvisor Expedia spun off the online travel firm in 2011.

Demerger in practice

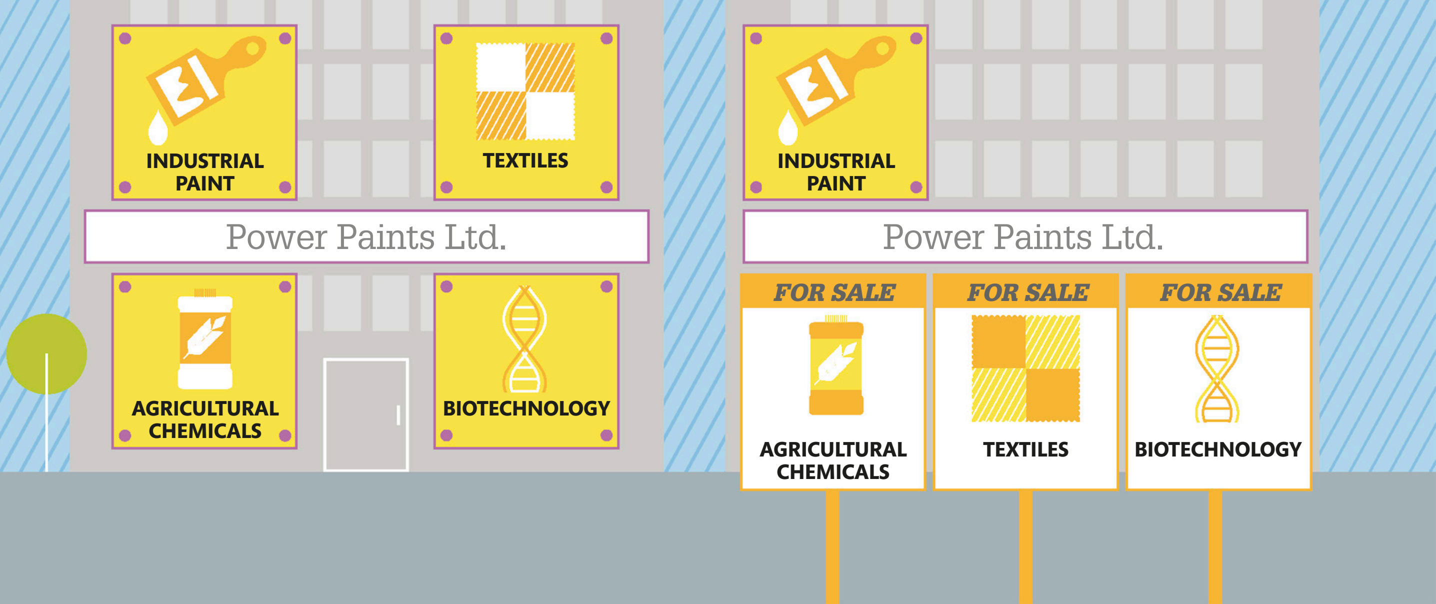
An industrial paint conglomerate, Power Paints Ltd., has grown rapidly over the past five years, due to an increase in profits from its expanding sales in China. The company diversified into agricultural chemicals, textiles, and biotechnology and set up a separate division for each. Share prices fell in response to poor financial performance.

Making a decision

Faced with a downturn in business, the company demerges the newer business areas that have not yet shown strong returns despite positive signs of growth.

Announcing the sale

Power Paints Ltd. now announces the sale of its three remaining divisions: agricultural chemicals, textiles, and biotechnology.



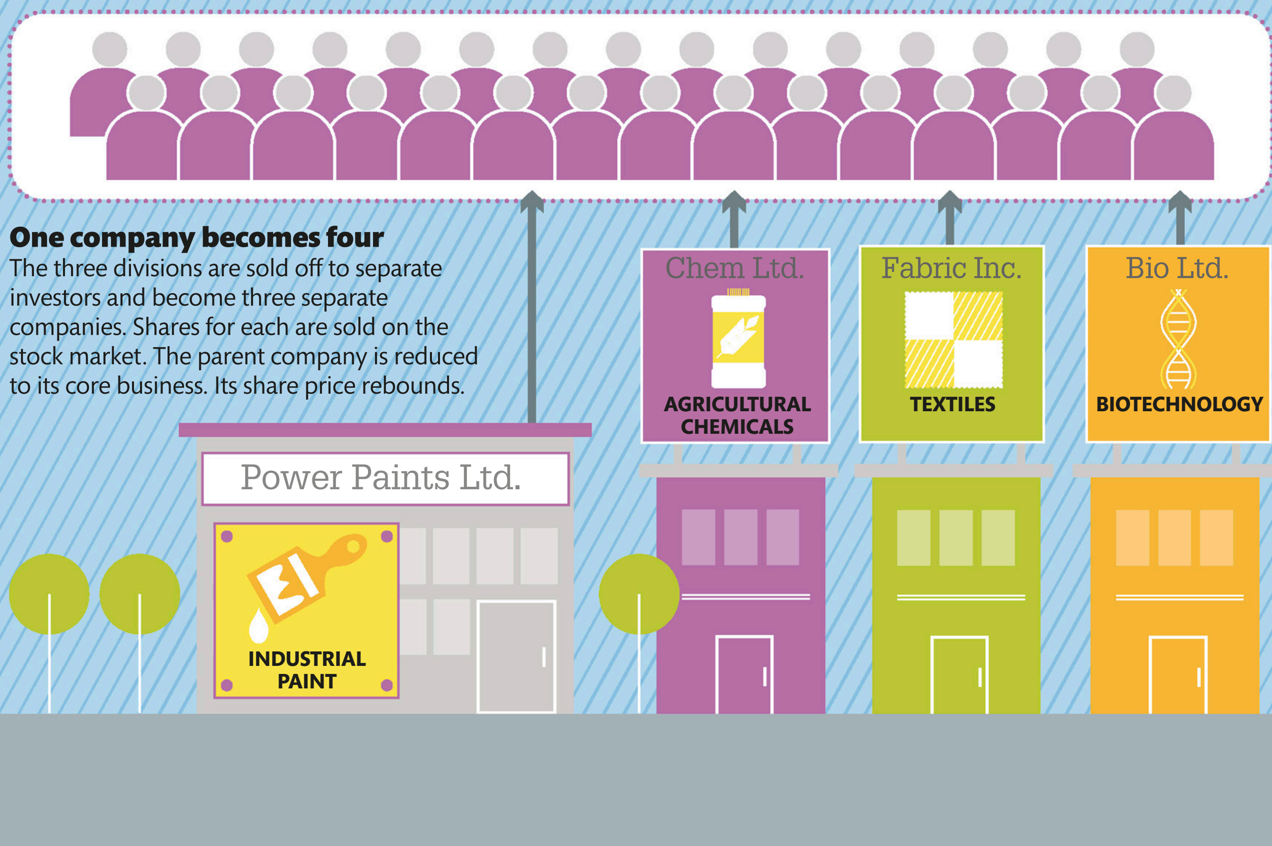
✓ NEED TO KNOW

- **Spin-off** New company formed as the result of a demerger
- **Tracking stock** Special type of shares issued by a parent company for the division or subsidiary that they will sell; tracking stock is tied to the performance of the specific division rather than to the company as a whole; also known as targeted stock
- **Letter of intent** Letter stating serious intention to do business, often concerning M and A
- **Reverse merger** Not to be confused with a demerger, this is a quick and cheap method for a private company to go public by buying a shell stock—a public company that is no longer operating because it went bankrupt or was simply closed
- **Divestiture** Term commonly used for a demerger

3.3% the average rise in a company's share price following a demerger announcement

The shareholders benefit
Shareholders in the original company also receive the same percentage holding in shares of the three new companies.

One company becomes four
The three divisions are sold off to separate investors and become three separate companies. Shares for each are sold on the stock market. The parent company is reduced to its core business. Its share price rebounds.



Vertical vs. horizontal integration

Companies that want to expand through a merger or an acquisition may decide on a strategy of either horizontal or vertical integration, combining businesses involved in similar or dissimilar activities.

How it works

Companies can choose from several strategies when they merge or are part of an acquisition. Two of the most common are horizontal and vertical integration.

Horizontal deals are made between competitors that produce similar types of products, such as cars or cell phones, and often share—or compete for—the same suppliers and clients. As a result of merger or acquisition, the newly formed company can save costs in production, distribution, sales, and marketing. Vertical deals are usually made between businesses involved in the same industry but at different stages—for example, a computer and a component manufacturer. These deals can be upstream (toward the market) or downstream (in the direction of operations and production).

NEED TO KNOW

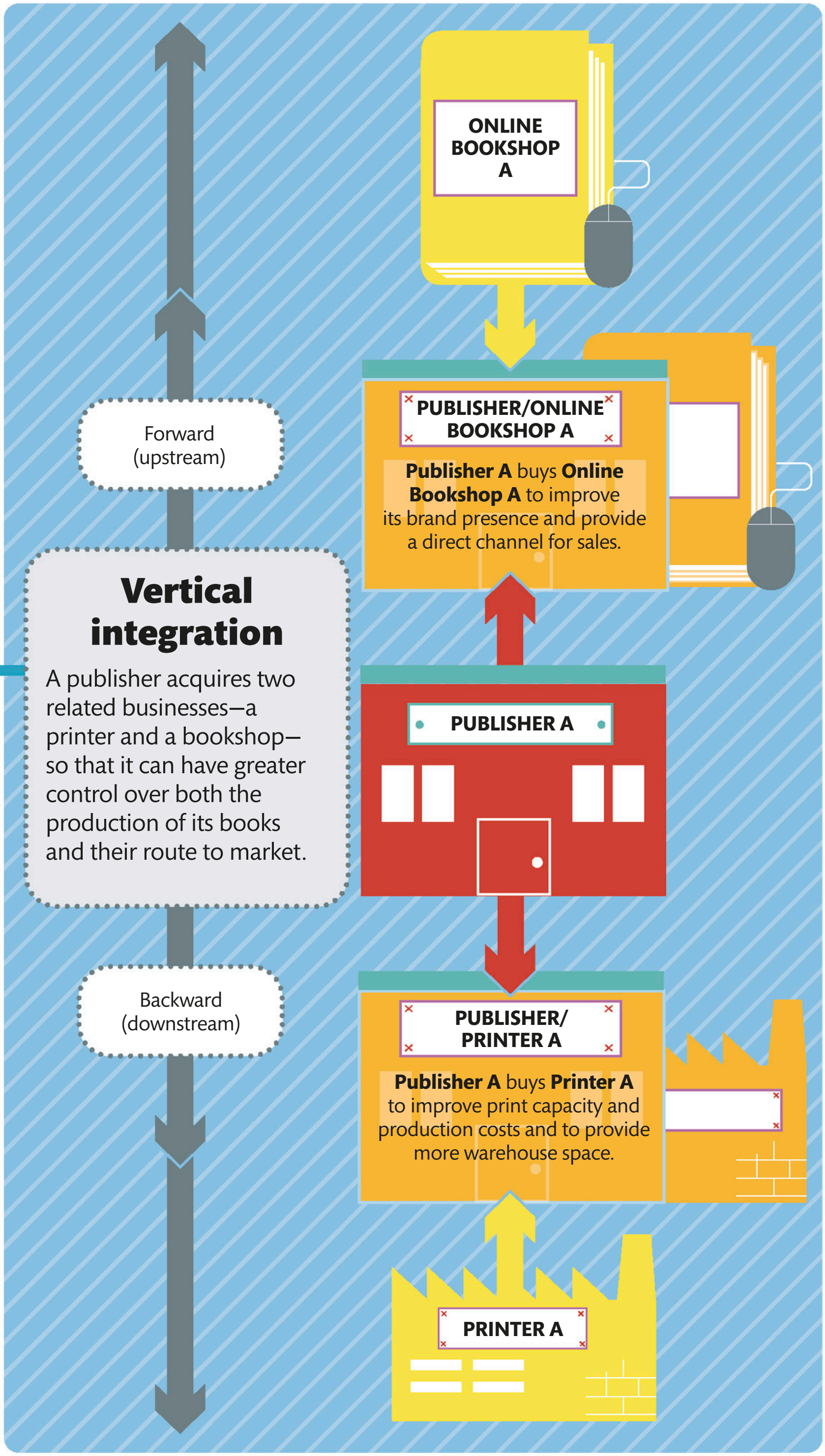
- **Lateral integration** Another term for horizontal integration
- **Horizontal monopoly** When a company controls the market after buying up the competition
- **Synergy** Potential of merged companies to be more successful as a single entity

Integration models in practice

In these hypothetical examples, a cluster of printers, publishers, and bookshops merge or acquire each other in horizontal or vertical deals that aim to strengthen their market position, take advantage of economies of scale, and exploit synergy.

Horizontal integration

Two publishing companies, both involved in the process of book creation but with different areas of specialization, agree to a merger deal to gain a larger market share.



Vertical integration

A publisher acquires two related businesses—a printer and a bookshop—so that it can have greater control over both the production of its books and their route to market.

86%

of M and A deals do not exceed initial expectations for income or rate of return.

MERGER AND ACQUISITION TYPES

Horizontal

When two firms in a similar field merge, usually to take advantage of economies of scale, share skills and resources, and reduce competition. The merger of Facebook and Instagram is one example.

Vertical

When firms in the same supply chain come together. It is sometimes done to ensure supply and control over raw materials—for example, when a garment manufacturer acquires a cotton producer.

Conglomerate

When firms in different industries come together. One advantage is the cross-selling of products or services to a larger customer base. One example is food corporation Danone's acquisition of Dutch company Numico, which helped it expand into the baby food and nutrition market.

Management buy-ins and buyouts

A company's ownership may undergo a change, which can be driven either externally, known as a management buy-in, or internally, known as a management buyout.

How it works

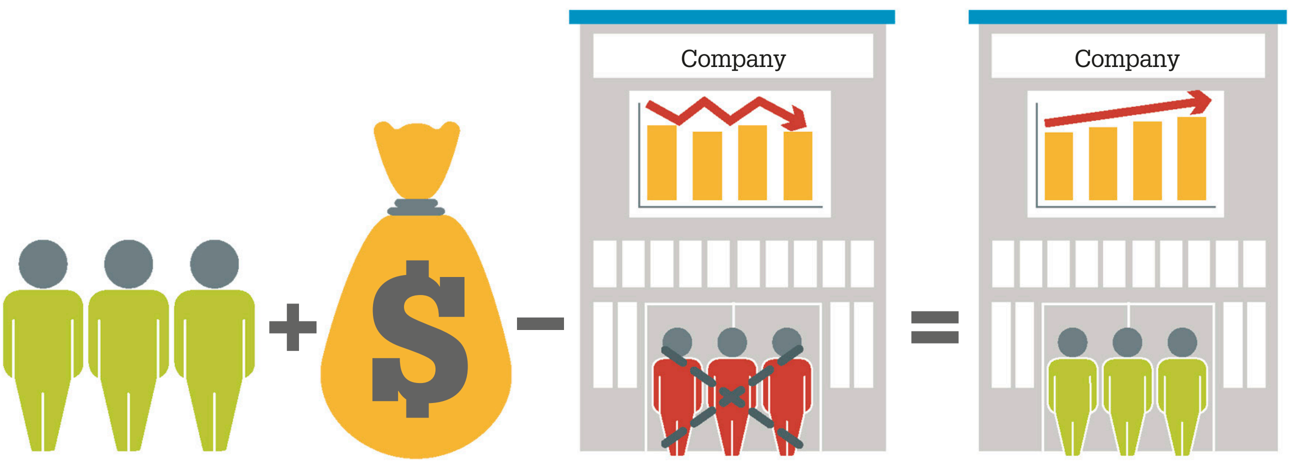
In a management buy-in (MBI), a group of managers or investors from outside the company raises the money to buy a majority stake in the company and then takes over its management. This type of action occurs when a company appears to be either undervalued or underperforming. In a typical management buyout (MBO), the company's existing management team purchases all or part of the company that they work for. Despite the name, MBOs are not restricted to managers, and they can include employees from any level of the organization who wish to make the transition from employee to owner.

NEED TO KNOW

- **Earn-out** Percentage of the purchase price paid to the sellers after acquisition if the business has performed as expected
- **Leveraged buy-out** Acquisition of a company using equity and borrowed money, with the company as loan collateral

Buy-in

Some companies, such as investment banks or venture capitalists, can make sizeable profits by purchasing undervalued businesses and transforming them.



An outside management team or investment group sees that a company is undervalued.

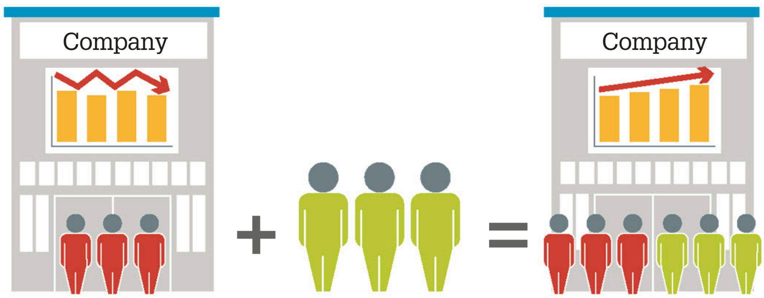
They raise funds to buy a majority shareholding.

They fire and replace the previous management team.

They overhaul the business to improve performance and realize its true value.

BUY-IN MANAGEMENT BUYOUT (BIMBO)

In this type of transaction, the existing management of a company stages a buyout, but additional external management is brought in by financers to strengthen the company's leadership and to provide expertise in particular areas that might be lacking in the original team.



Existing management buys company.

Outside management is brought in.

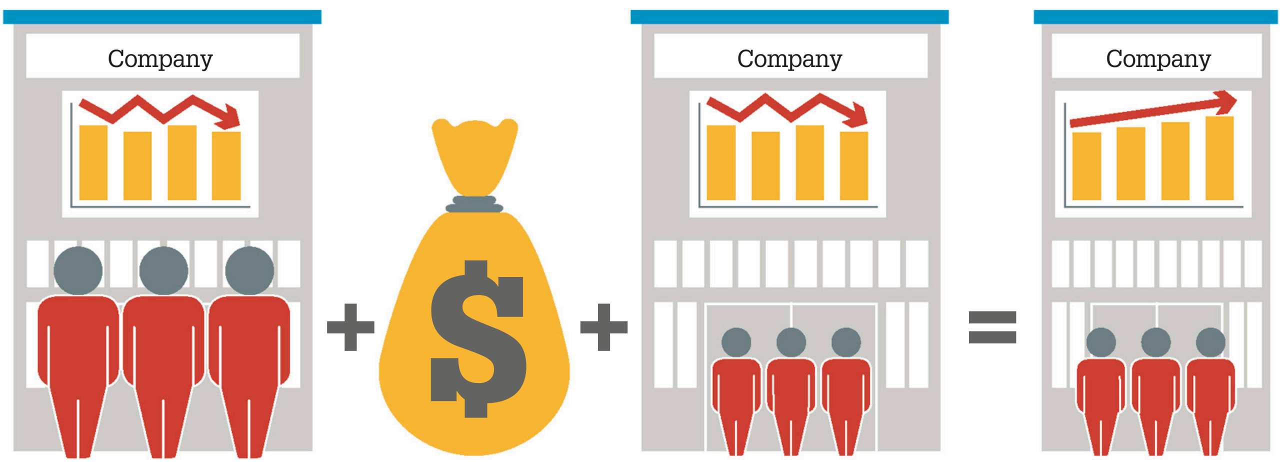
New management team

9:1

the typical ratio of debt to equity in a leveraged buyout

Buyout

A buyout allows a company to sell off all or a part of the business or it helps a small business owner retire or move on.



The management team sees an opportunity to take ownership when their corporate division is put up for sale.

They raise funds via bank loans, private investors, their own capital, or a loan from the seller.

They buy the business.

The management team, who now owns the company, streamlines the business to make it more profitable.

Who's who

A company's structure and hierarchy will develop as the business grows. The tendency now is to cut down on unnecessary layers of management and to ensure that everyone in the organization knows what their role is and to whom they report. Most important is that the hierarchy fits the type of business and that authority is delegated to the appropriate level to enable timely decision making.

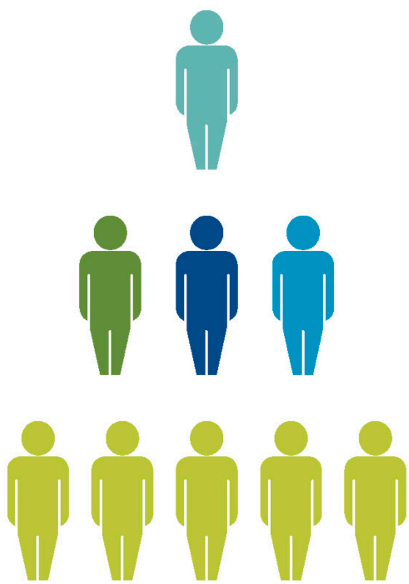
Who's who in an organization

Stakeholders and shareholders

Stakeholders are anyone with a vested interest in the company. Shareholders are stakeholders who have bought stock in the company. *See pp.60–63*.

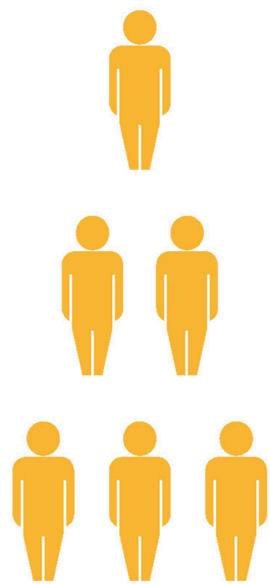
Board of directors

The board of directors makes sure that the company is run profitably to provide returns to shareholders. The board votes in a chair, who is sometimes also the chief executive officer (CEO). *See pp.52–55*.



C-suite executives

The top level operates the company day to day and sets strategy. Known as the C-suite because all job titles begin with a "C" for "chief," it is headed by the CEO. *See pp.56–59*.



1/3

of global employees strongly agree that they trust the leadership of their organization.

FRONT LINE AND BACK OFFICE

Some employees are directly involved in operational activities, such as making goods and delivering services, or marketing and selling them. They are sometimes said to be working on the front line. Their work is important, but they cannot function without the support of back-office staff. These staff include people working in such roles as finance, IT, and human resources. It is important to ensure that both groups work well together to enable the business to run smoothly.

Mid-level management

Division and department heads are usually called directors or managers. Jobs at this level are often the first to go when a company downsizes or restructures. *See pp.56–59.*

Junior management

Supervisors, managers, or team leaders directly manage groups of employees carrying out specific tasks. Examples include a head nurse or a foreman. *See pp.56–59 and pp.74–75.*

Nonmanagement employees

These include skilled and nonskilled workers but also people recruited for their expertise, such as tax specialists and scientists involved in research. *See pp.56–59 and pp.74–75.*

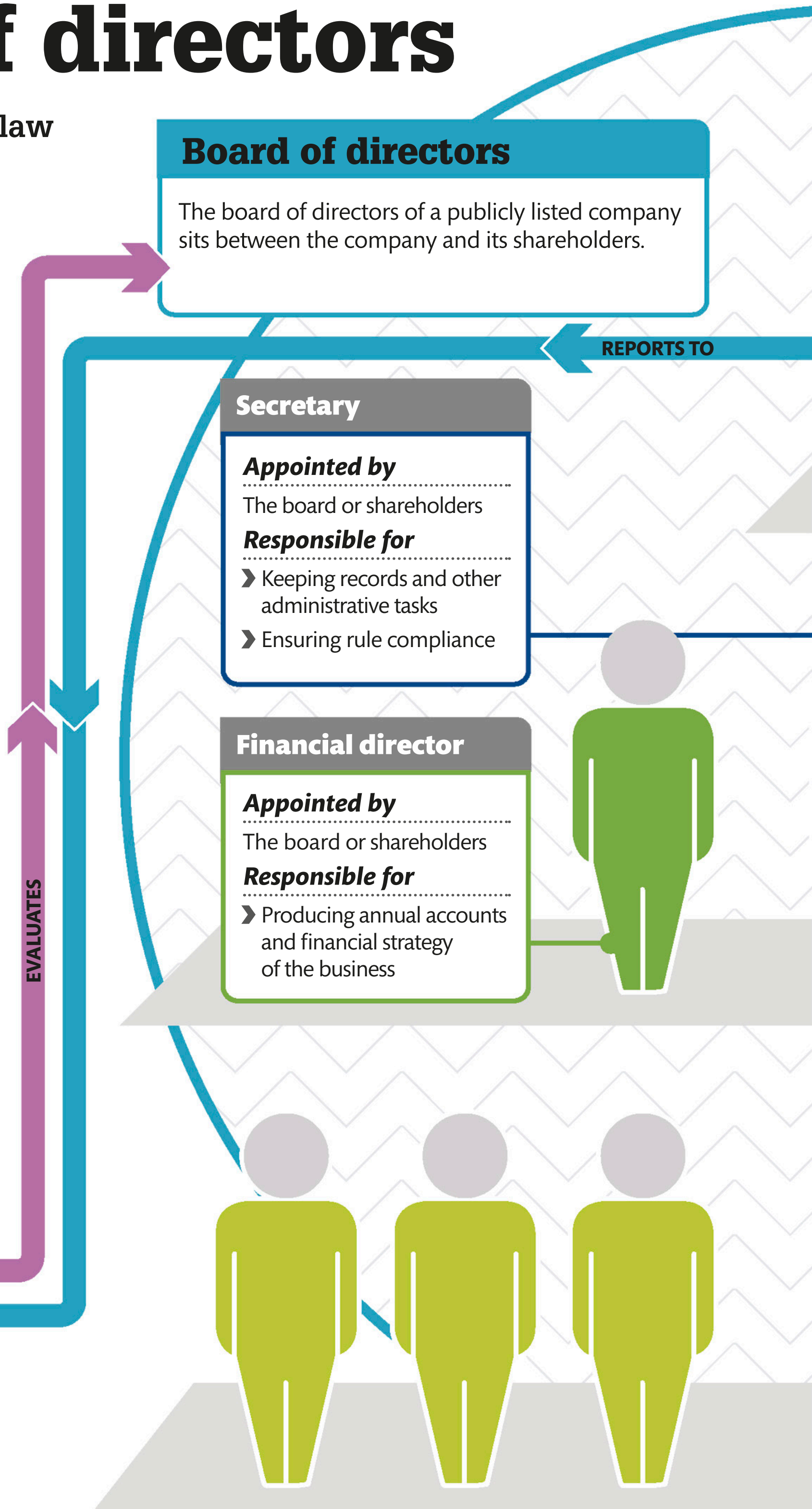
Board of directors

Public companies are required by law to appoint a board of directors to provide oversight.

How it works

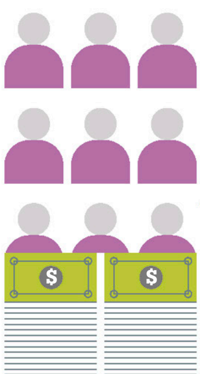
All companies must have at least one director. If a company goes public and issues shares, it is legally required to have a board of directors. The board is made up of experienced business advisers who provide independent oversight of the company for shareholders and are mandated by law to govern the company responsibly.

Board members may come from within the company or be independent outsiders and should cover a range of expertise—such as legal, financial, and marketing—or have specialized industry knowledge. Networkers are also highly prized for their ability to build connections with influential figures in the corporate and governmental spheres. Shareholders or board members elect roles, such as chair (president in some organizations), vice chair (or vice president), secretary, and financial director, although the exact structure will vary from company to company.



Shareholders

Any person or institution that has bought shares in a publicly listed company is a shareholder. The board works for the shareholders, who effectively own the company.



Chair

Appointed by

The board or shareholders

Responsible for

- Publicly representing the company's policies
- Leading the board, conducting board meetings
- Determining the composition of the board
- Mentoring and monitoring the CEO or managing director (MD)
- Communicating with shareholders

Vice chair

Appointed by

The board or shareholders

Responsible for

- Standing in for chair
- Undertaking special projects for chair
- Assisting chair in balancing experience, personality, and age of directors on board

Directors

Appointed by

The board or shareholders

Responsible for

- Determining strategy
- Monitoring achievement of implemented policies
- Appointing managers
- Accounting for company's activities to shareholders and other stakeholders
- Non-executive directors are not employees of the company and offer objective advice and expertise

16 the average board size in Austria, versus 10 in the U.K.

REPORTS TO

EVALUATES

Company

Responsible for day-to-day production, sales and marketing operations, and finance. The company reports to the board via its chief executive officer (CEO), who executes the board's decisions.

CEO

Appointed by

The board or shareholders

Responsible for

- Performance of the company
- Implementing board strategy
- Leading senior management
- Reporting back to chairman and board

REPORTS TO

EVALUATES

Management

Managers pass the CEO's decisions down to employees.

Balancing the board

The board has three clear areas of responsibility: developing business strategy, advising the company, and overseeing how the firm is run. Selecting the right mix of directors to fulfill these functions is crucial.

Board members may come from inside or outside the company. Those who work for the company (executive or internal directors) have more expertise in running the business, but independent members (non-executive or external directors) are better placed to offer perspective, scrutinize the actions of company executives, and call them to account. When potential conflicts of interest arise between management and shareholders, independent directors can weigh decision-making in favor of acting in the company's best interests.

The ideal balance is a hot topic in corporate governance. In US companies, CEO and chairman roles have traditionally been combined, but following a spate of corporate scandals, the roles are now more often vested in two individuals. In Europe, keeping the roles separate has long been seen as best practice.

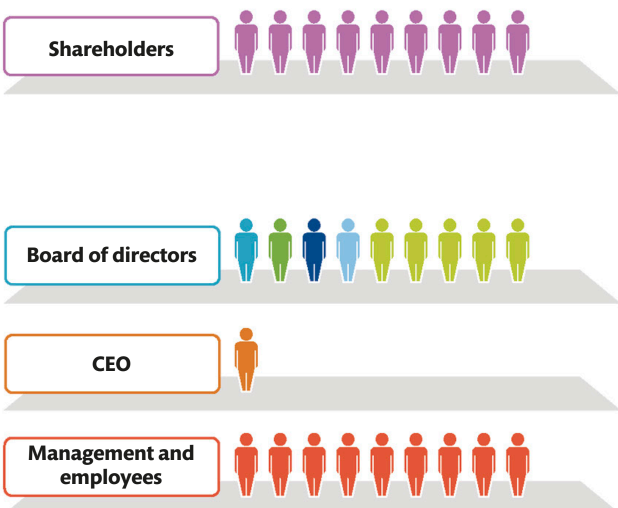
NEED TO KNOW

- **NEDs** Non-executive directors, also known as independent, external, or outside directors
- **Executive directors** Board members who also work for the company—not to be confused with the term executive director when used as a title for the CEO
- **Model Business Corporation Act** Developed by the American Bar Association, this model is used as the basis for corporate governance in the US

Board structure variations

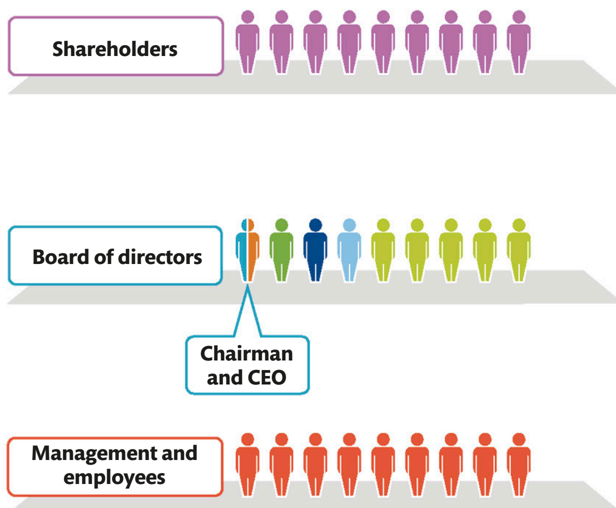
Independent board of directors

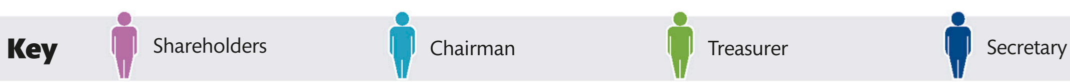
The board sits between shareholders and company. The CEO is the main channel of communication between board and company, while the chairman is the principal conduit between shareholders and board. This structure gives the board most independence.



CEO as chairman

A setup in which the company's CEO serves as the board's chairman. While this offers less independent scrutiny of finances, strategy, performance, and pay, it avoids duplication of roles. This setup is found in US corporations and in many small- and medium-sized companies in other countries.





WHAT DO BOARD MEMBERS DO?

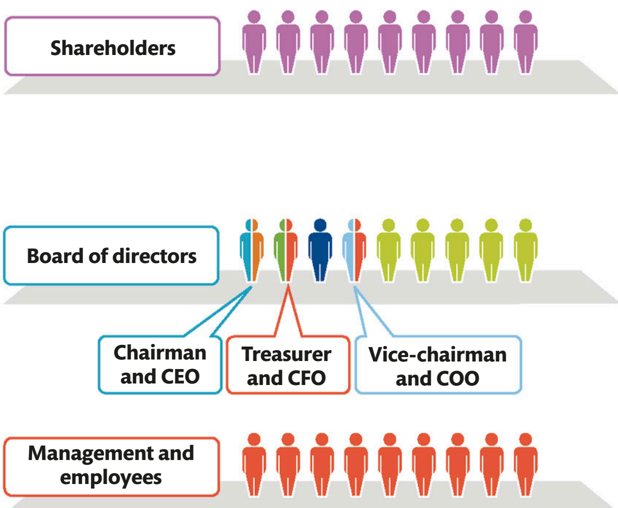
The board exists to ensure the success of the company and to meet the appropriate needs of its stakeholders. It must enable the business to move forward but also exercises control. Some tasks are carried out by the members of the board themselves – these include establishing the vision and values for the company and setting strategy. Others are delegated to senior managers, such as deciding how to implement a particular strategy.

Different companies face different legal requirements for their boards, depending on whether the company is public or private, and where it is located globally. These requirements typically relate to matters such as the filing of accounts and the accurate recording of board meetings. Company board members are answerable to both shareholders and to regulators.

97% of French boards have at least 30% female directors, compared with 43% in the US and 3% in Japan

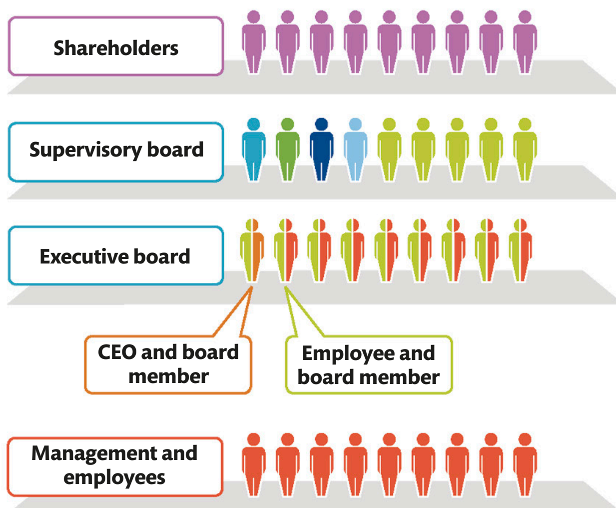
Senior management as directors

A structure in which senior managers also sit on the board. The chief financial officer (CFO) is appointed board treasurer and the chief operations officer (COO) is vice-chairman. In some countries (Germany, for example), employees must be included on the board by law.



Two-tier board

An arrangement that is made up of separate supervisory and executive boards. The supervisory board is composed of outside directors, led by a chairman. The executive board comprises senior managers, including the CEO. The two boards always meet separately.



Company hierarchy

Almost every organization has a structured arrangement of levels for members, from the board of directors at the top to junior employees at the bottom. There is a trend toward reducing the number of levels.

How it works

There are five levels in the conventional corporate structure, with a line of authority from top to bottom. The chief executive officer (CEO) is the highest-ranking person in the company, reporting to the board of directors and sometimes also sitting on the board. Reporting to the CEO are a number of high-level executives, known as C-level executives, as their job titles often begin with a "C." Below the C-level is management, in tiers that differ from company to company, with employees forming the bottom level. As well as skilled and unskilled employees, there may be staff on fixed-term contracts, taken on for the duration of a project or for a set length of time, in addition to consultants brought in for special purposes. There could also be casual temporary workers as well as outsourced workers—the employees of an external company contracted to operate in a certain area of the business.

C-SUITE VARIATIONS

The range of C-level positions varies for each company. As well as the three top posts, there may be:

CAO Chief Administrative Officer

CIO Chief Information Officer

CTO Chief Technology Officer

CPO Chief Product/Production Officer, responsible for overseeing product development and production

CMO Chief Marketing Officer, responsible for marketing strategy and business development

C-level positions are evolving, adapting to market conditions and business priorities. New roles are emerging, while some traditional roles are disappearing. The role of COO, for example, is less popular in modern organizations. Some of the new roles include:

CPO Chief Privacy Officer

CSO Chief Sustainability Officer

CDO Chief Digital Officer

CKO Chief Knowledge Officer

CCO Chief Customer Officer

51%

of CIOs and CTOs say they are pioneering digital approaches within their business.

C-suite executives

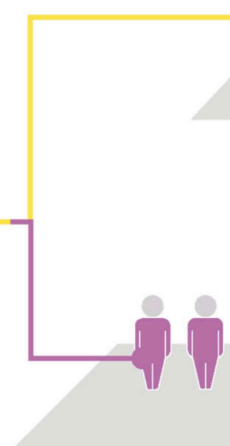
These are the most senior jobs in the company, with the CEO at the top, the COO and CFO traditionally on the next level down, and other C-positions below that. In many companies, the C-level positions have equal authority, and all report directly to the CEO.

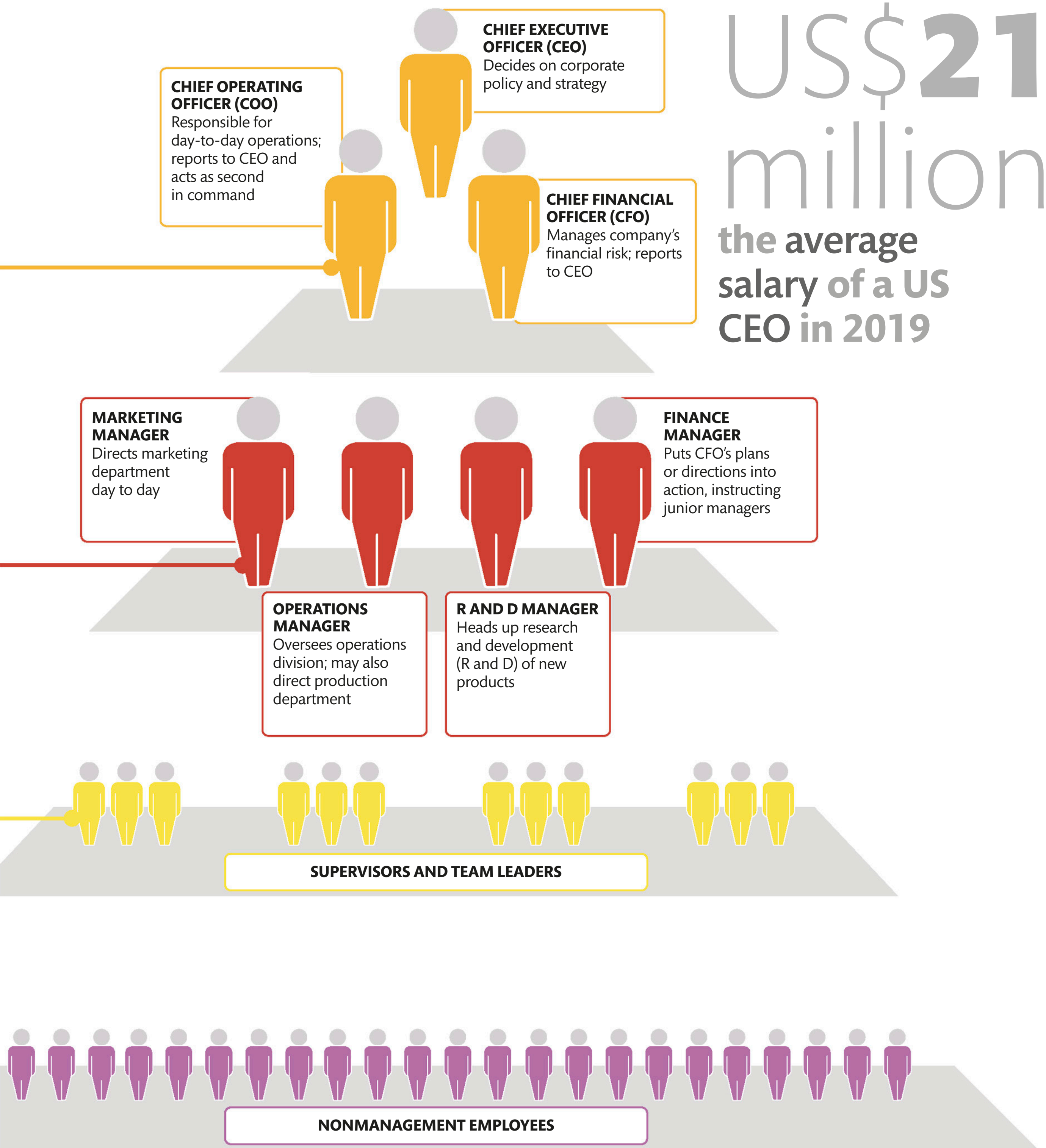
Mid-level management

Responsible for overseeing specific functions in the organization, the most senior managers at this level head up different departments or divisions. These managers are often called directors (not to be confused with the board of directors) or vice presidents. The exact job titles and the number of mid-level managers vary, depending on the company.

Junior management and other employees

Team leaders, such as supervisors and assistant managers, implement management plans. They also coordinate teams of skilled and unskilled workers in, for example, production, customer service, and sales to carry out the core tasks needed for the company to function efficiently and profitably.





US$21 million the average salary of a US CEO in 2019

Flattening hierarchies

The trend in management over the past few decades has been to eliminate layers from company hierarchies, which means they are becoming flatter—in other words, there are not as many levels to go through in order to reach the top.

In most cases, this has involved stripping away management positions in order to increase communication and collaboration across all levels. For example, the role of chief operating officer (COO) has been disappearing in recent years, as have layers of middle management, with many more division heads now reporting directly to the CEO. In such cases, some degree of hierarchy is maintained, but other companies go even further, evolving to completely flat hierarchies with no bosses at all. However, such approaches tend to work best for smaller firms, proving less scalable in larger organizations.

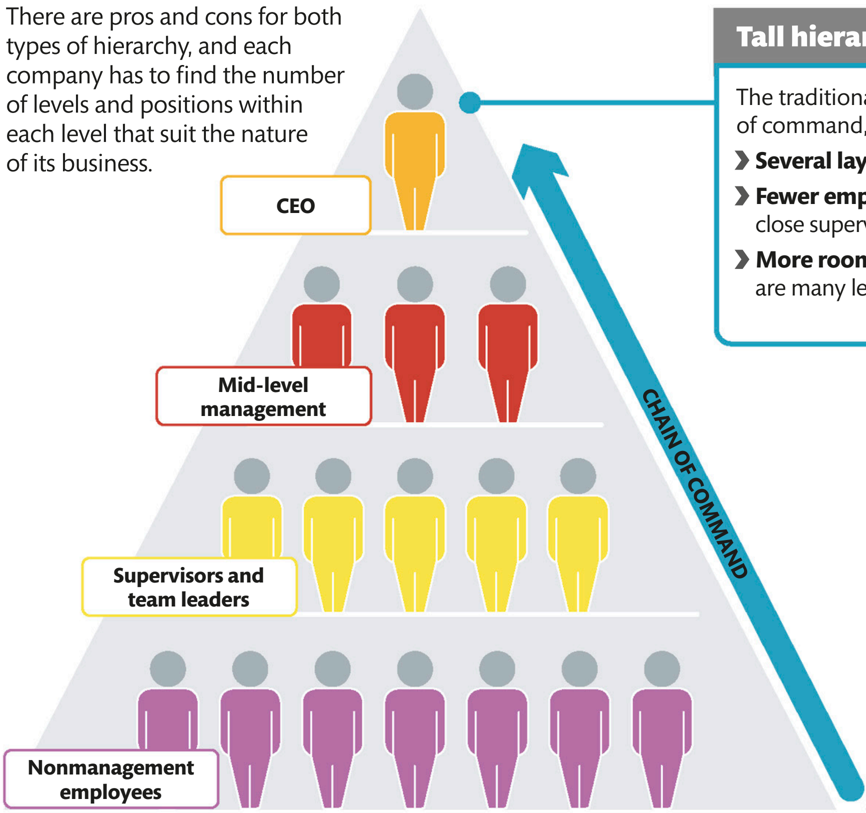
Sometimes companies decide to restructure the other way around instead—from flat to tall—by eliminating a number of senior management posts and replacing them with a greater number of junior supervisory roles.

NEED TO KNOW

- **Span of control** The number of employees reporting to a manager or other senior level; the greater the span of control, the more workers reporting to an individual above
- **Line position** Job role with responsibility for achieving the goals of the organization
- **Staff position** Job role providing expertise to assist someone in a line position

Tall vs. flat hierarchies

There are pros and cons for both types of hierarchy, and each company has to find the number of levels and positions within each level that suit the nature of its business.



Tall hierarchy

The traditional model is suitable for a formal chain of command, such as in the military.

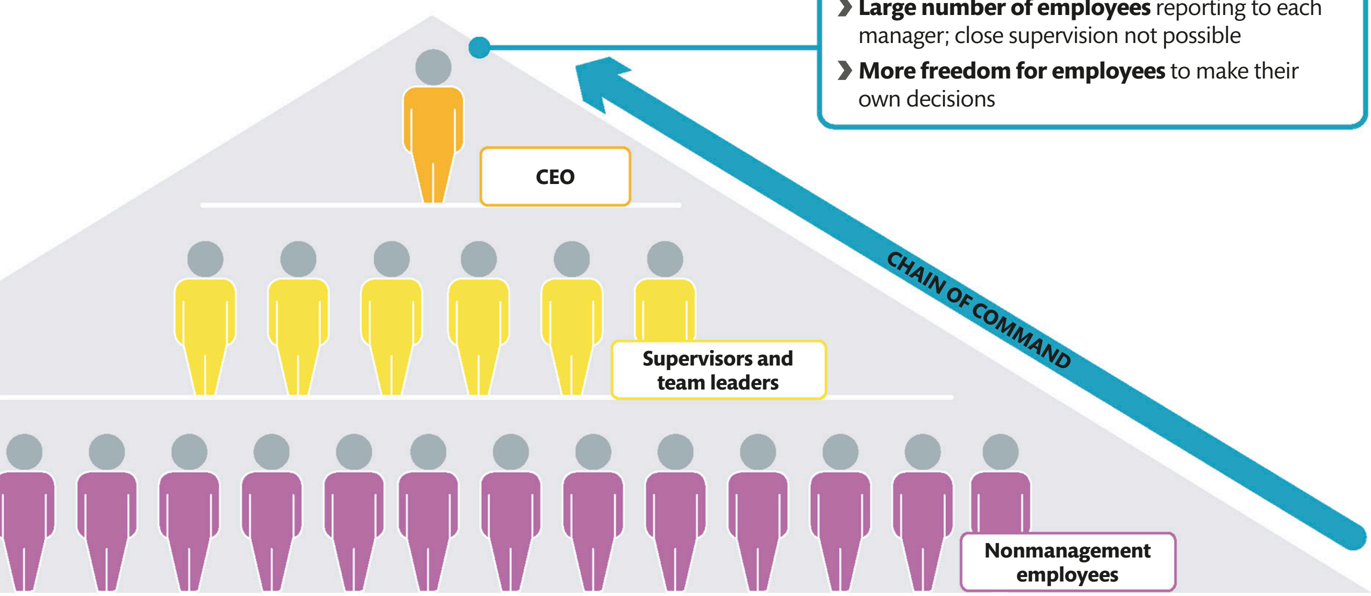
- **Several layers** from top to bottom
- **Fewer employees** reporting to each manager; close supervision possible
- **More room for career advancement**, as there are many levels to rise through

CASE STUDY

Going flat at Valve

Valve is the developer behind such hit video games as *Half-Life* and *Portal*. Believing that its hierarchical structure was holding back innovation, management decided to switch to a flat structure. Now, Valve has no bosses, and staff are free to work on the projects they want. In return, they take responsibility for their mistakes and the products they create. While many people thrived in the freer environment, others struggled to adapt and departed. The firm also saw numerous projects abandoned after they failed to gain momentum. The experience led Valve to tweak its radical approach, maintaining its flat structure but uniting staff temporarily to focus on a new *Half-Life* title. As one developer admitted, "We were wrong on the premise that you will be happiest if you work on something you personally want to work on the most." Released in 2020, *Half-Life: Alyx* was immediately acclaimed as a landmark in virtual reality gaming.

14% of executives believe that a traditional hierarchical model makes their business highly effective.



Flat hierarchy

This looser model is more flexible and suitable for companies that foster creativity.

- **Only a few layers**, so mid- and low-level management are merged
- **Large number of employees** reporting to each manager; close supervision not possible
- **More freedom for employees** to make their own decisions

Stakeholders

A stakeholder is anyone who is affected by the operations of the company, directly or indirectly. Stakeholders include such groups as employees, shareholders, regulators, suppliers, and customers.

How it works

Companies have an impact on many groups of people through their operations. These include employees, who rely on them to pay salaries, and customers, who want the products and services that they supply. It is important for managers to understand what all these various stakeholders are looking for from them, whether they can meet their needs, and if so, how.

Sometimes, the needs of stakeholders conflict. For example, a community may rely on a business to provide local employment opportunities but will likely be unhappy if the operations of the business are noisy or cause pollution. In such cases, the managers of the company must find ways to maximize the benefits to stakeholders and minimize the drawbacks.

Stakeholders' areas of interest

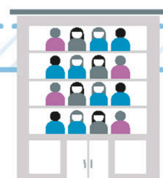
Different stakeholder groups take different levels of interest in different factors. Some predominantly care about a company's environmental, social, and governance (ESG) factors. Others may be more interested in its financial performance, while still taking ESG concerns into account. Shareholders, for example, want profits, but they also understand how sustainability is key to long-term growth and may want to invest their money ethically.

Stakeholders with ESG concerns

Stakeholders have no direct involvement but believe that companies have a responsibility to the communities they operate in to respect the environment, human rights, and animal welfare.

$892 million

the average drop in market value triggered by negative news about a company's human rights record



Nongovernmental organizations

- Contribution to environmental and social causes
- Legal compliance

Community

- Impact on local inhabitants
- Concern for broader social welfare

Stakeholders with economic and ESG concerns

Stakeholders use ESG—a recognized part of policy and reporting for most companies—to evaluate corporate behavior and to determine future financial performance. Concerns range from profits to ethics.

Government
- Tax payments
- Legal compliance

Shareholders
- Ability to pay dividend
- Increase in share value

Customers
- Quality product
- Value for money
- Customer service

Trade unions and labor unions
- Treatment of workers
- Fair pay, benefits, and working conditions

Suppliers
- Ability to pay debt
- Enough liquidity

Employees
- Pay and benefits
- Longevity of the company
- Employment prospects

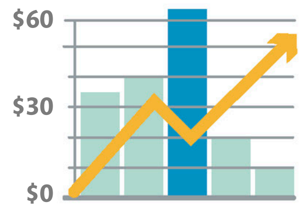
Lenders
- Ability to repay loans
- Integrity of management
- Financial strengths of the company

Stakeholders in action

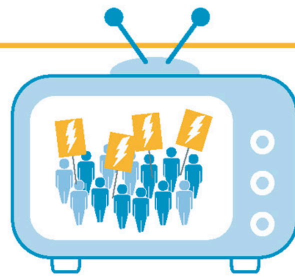
Compared with other stakeholders, shareholders have the most interest in the financial performance of a company. They are also forced to take an interest in how seriously the company takes its corporate responsibility (CR), whether or not they are socially and environmentally conscious themselves. Several high-profile cases have shown how stakeholder reaction has caused a significant decline in share prices. By using social media, stakeholders can generate a storm of public disapproval, leading to angry consumers and nervous investors.

How stakeholders affect share value

In April 2010, an offshore oil rig owned by British Petroleum (BP) exploded in the Gulf of Mexico. BP attempted to alleviate stakeholder concerns, but stakeholders responded negatively, starting their own social media campaigns to shame the company. Sixty-six days after the oil spill, BP's share value on the New York Stock Exchange had dropped by 52 percent.

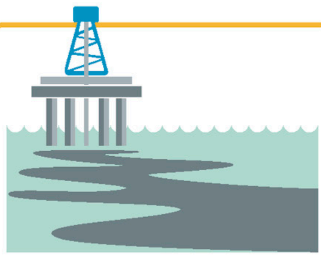


BP shares are trading at **$60.57** on April 20, 2010.

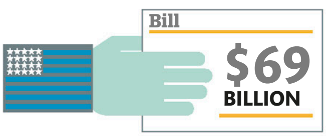


News media report on the stakeholder backlash.

Stakeholder social media campaign intensifies.

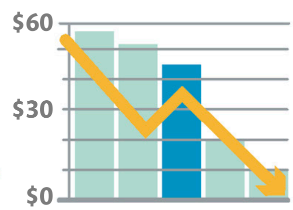


News breaks that spill is worse than BP claims.



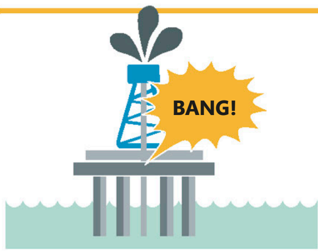
US government's Obama administration criticizes BP and sends company $69 billion bill for cleanup.

Obama administration advises that it could take legal action to stop BP from paying dividends to shareholders.

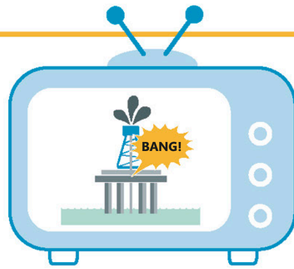


Share price drops 7 percent in London trading.

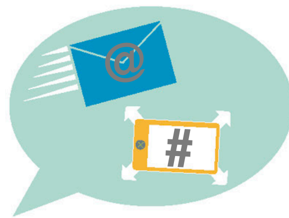
$132 billion invested in European ESG funds in 2019



Oil rig explodes, killing 11 employees and spewing millions of gallons of oil into the Gulf of Mexico.



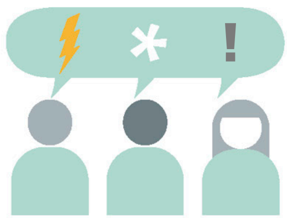
News media report on the event.



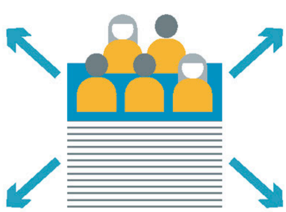
BP starts social media campaigning on Twitter, initially to minimize the impact of the spill.

Stakeholders of the BP oil spill

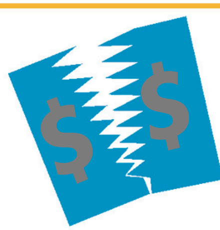
- Inhabitants along the affected coastline
- Local fishermen
- Oil spill cleanup workers
- Environmental activists
- BP employees
- BP shareholders
- Gas customers
- Tourists and tourist businesses
- Media
- Government
- General public



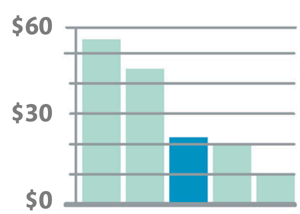
Stakeholders use social media to voice anger and concern over perceived lack of responsibility by BP. Conservationists warn of wildlife devastation. Celebrities offer to help with the cleanup. Stakeholders call for more disclosure from BP.



Five of BP's top 10 shareholders sell off stock.



By June 25, BP's share price has more than halved; more than 34 billion shares have been bought and sold.



BP shares are trading at **$23.91** on June 25, 2010.

Business cultures

Every organization has a particular workplace culture, consciously or unconsciously shaped by the personalities, values, and behavior of the people leading it and working in it.

How it works

The organizational culture of every business is different, reflecting the ethos of the company, the workplace habits, and the image the company projects. It is also tied to the type of work that is done. In a high-stakes financial trading company, the pace and pressure of the work makes the atmosphere crackle, whereas in a firm relying on creativity for its products, the mood is likely to be more relaxed. The type of incentives offered to management and employees may also affect the workplace, creating either a competitive or collaborative culture, or a mix of both. The increase in remote working is also leading to many changes in cultures.

✓ NEED TO KNOW

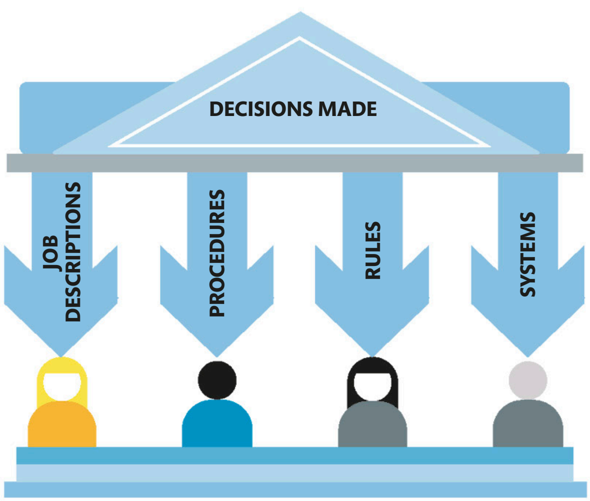
- **Control systems** Used by managers to set standards and measure performance
- **Leverage** Power to influence a person or situation
- **Paradigm** Value system of goals, mission, and beliefs

Types of corporate culture

Management experts have tried to explain how organizational cultures work. Charles Handy, a former professor at the London Business School, describes them in terms of four major types: power, task, role, and person.

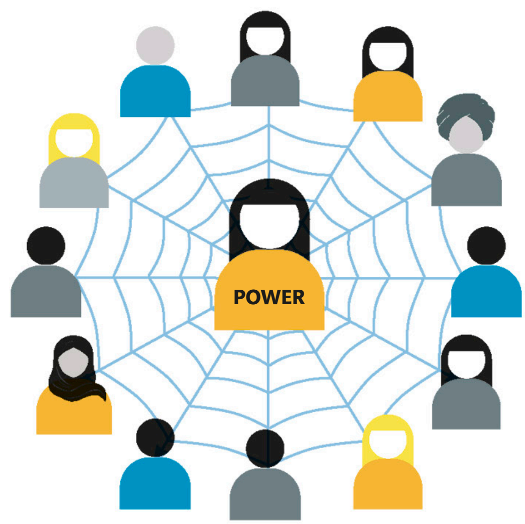
Role culture

Where a company is based on the structural support of specialized roles. Each role is crucial and will persist even if the person occupying it leaves. Procedures and systems are strictly followed, as in a government department.



Power culture

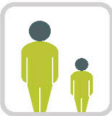
Driven by a powerful individual at the center of the organization, who is relied on for decision making and the company's successes. Those closest to the center have the most influence. Typical of a family-owned business.



bureaucratic / controlling

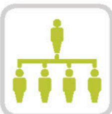
WHAT SHAPES CORPORATE CULTURE?

Many factors reinforce a culture. To bring about change, the workforce needs to be inspired by different motivations, values, and types of role model.



Organization size
Big business or small company

Leaders
Their personality and behavior



Company structure
Strict hierarchy or power shared among many people

Symbols
Titles, dress codes, interior aesthetic

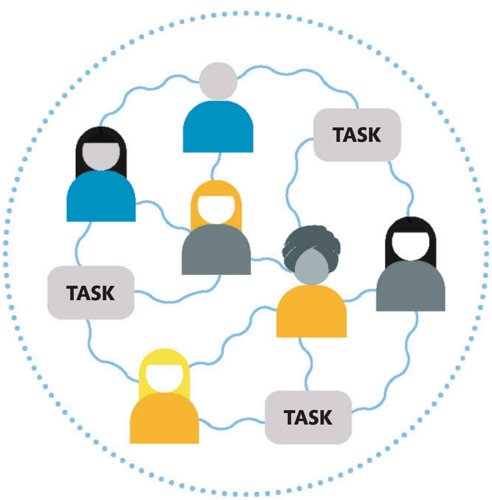
Founding values
Includes origination myths and stories

Control systems
Rewards, incentives, performance assessment

84% of senior managers in global organizations agree that organizational culture is critical to success.

Task culture

Project-oriented work where a project's completion is the motivating force. Relies on teamwork and individuals' expertise, but results are more important than personal objectives. Found in technology companies, for example.



Person culture

Company power and influence is shared among individuals who work semiautonomously. Individuals count for more than the company, which is made up of people with similar specialist training, such as in an architects' firm.

entrepreneurial / flexible

Corporate structure

A company's structure—the way in which it is organized—can have a major impact on the way it performs. There are several models of corporate structure typically used in the business world, and they continue to evolve—all the more so now as businesses embrace remote working. The first consideration is whether power should be centralized at the top, with decision making in the hands of a few key senior employees, or decentralized, with more power in the hands of staff.

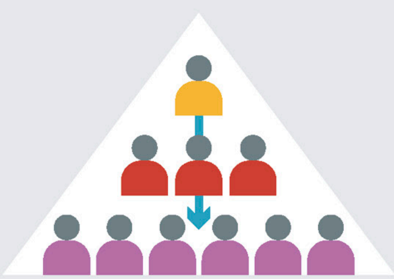
Choosing a structure

A company's structure changes as it grows. More complex structures will either evolve or be designed as a firm moves forward, depending on the nature and size of the business, the complexity of the work, any requirement for instant expertise, and the geographical location of parts of the business.

Centralized

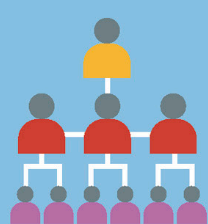
Power rests in the hands of a few people, with a long chain of command.

- Power at the top
- Rigid
- Conventional
- Inflexible
- Slow response to change



Functional

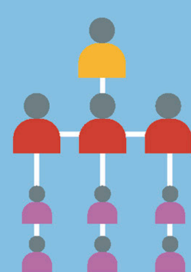
Good for strict control and formal relationships, as in the military.
See pp.68–69.



CEO COORDINATES

Divisional

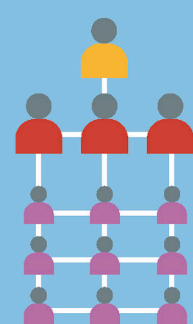
Suits companies with many global offices or product lines.
See pp.70–71.



CEO COORDINATES AND EACH DIVISION IS RESPONSIBLE FOR GENERATING PROFIT

Matrix

Good for large corporations with complex projects in different locations.
See pp.72–73.



DIVISIONAL AND FUNCTIONAL MANAGERS COORDINATE

78% of groups reach solutions to simple tasks faster in centralized structures.

100% of groups reach solutions to complex tasks faster in decentralized structures.

WARNING

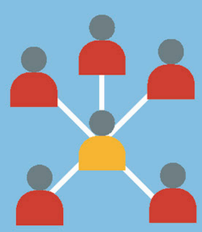
When change is needed

Signs that a structure is not working include low morale and high staff turnover, no new products being developed, and profit suddenly accelerating or decelerating. Tools to amend poor structure include:

- **Business process reengineering (BPR)** Analyzing and redesigning the workflow within a company.
- **Altering the reporting line** In a traditional solid-line reporting relationship, one line manager oversees goals and performance. It can be beneficial to switch to the weaker chain of a dotted-line reporting relationship, in which a manager sets some of but not all the objectives.

Network

Suits creative and technology companies in which everyone is online. *See pp.74–75.*



CORE COMPANY COLLABORATES WITH VIRTUAL COMMUNITY

Team-based

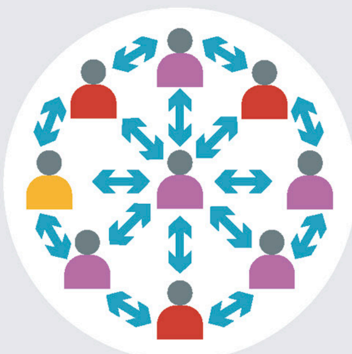
For companies that rely on innovation and are customer focused. *See pp.76–77.*

STAFF SELF-COORDINATE

Decentralized

Power is spread through the company, and staff make their own decisions.

- Power shared
- Organic
- Experimental
- Flexible
- Fast response to change



Functional structure

The classic way to organize a company is by dividing it into departments that reflect the main functions of the business, each headed by a director or manager.

How it works

The chain of command is straightforward. The business typically consists of a chief executive officer (CEO) or president at the top, with the various specialist departments or divisions, such as marketing and finance, aligned below.

Each department operates as an independent unit, with its own budget, and reports directly to the CEO, who takes responsibility for the operation of all the departments. A functional structure is the most common type of organization.

WARNING

Dangers of silo mentality

Silo mentality describes a scenario in which each department has a different, closed view of its role within the overall scheme, and information does not get shared.

1 Sales and marketing decides to launch a special online two-for-one offer.

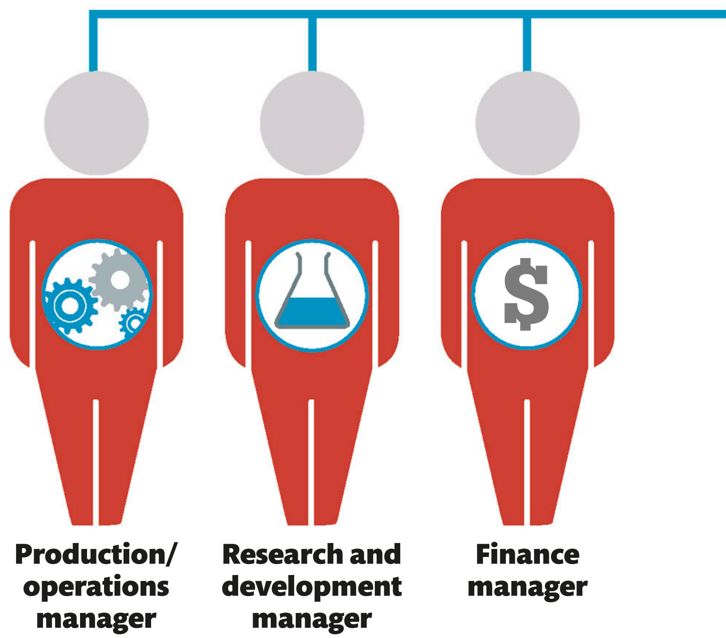
2 Finance is not briefed and processes the order for one item only.

3 Operations is not briefed and sends customers one item instead of two.

4 Customer service is not briefed and is unprepared for calls from angry shoppers.

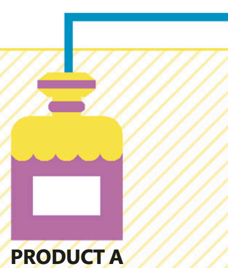
Typical departmental hierarchy

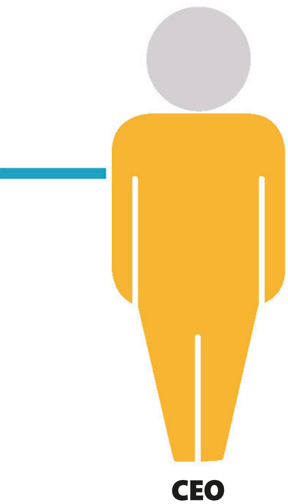
The departments operate independently, with the managers reporting to the CEO or president, who has overall command. The sales and marketing department usually takes responsibility for managing product lines.



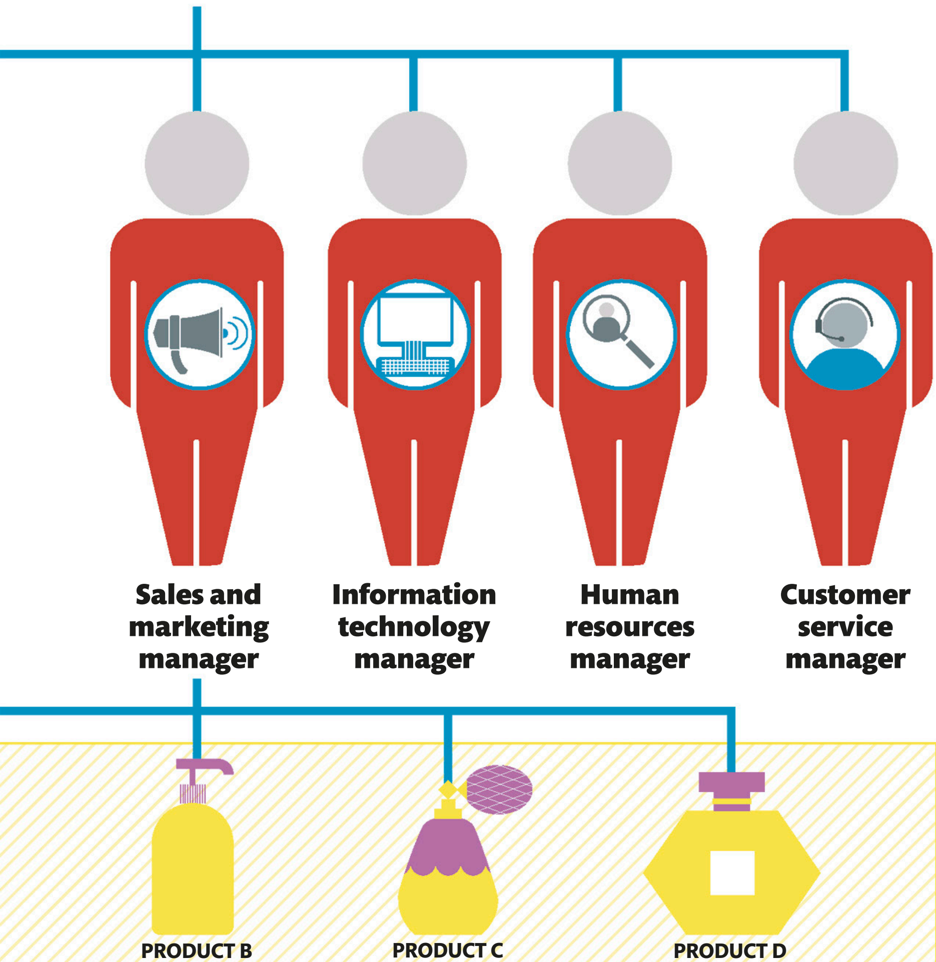
Deciding what to sell

The marketing department is closest to the market and is best able to analyse which product lines may do well. The sales and marketing manager can suggest what new products the company could make.





34% of companies say the structure of their organization is a barrier to improving customer experience.



FUNCTIONAL: PROS AND CONS

Pros

- Allows for the development of specialization and expertise
- Enables efficient use of resources and potential economies of scale
- Offers obvious career path for employees in each department
- Simple, efficient structure for manufacturers producing a limited range of goods for sale

Cons

- Formal lines of communication; stifles innovation and creativity
- Departments fail to coordinate with one another efficiently
- Response time on problems and queries between different departments slow
- Many decisions referred up to the top, creating a backlog

NEED TO KNOW

- **Line relationship** Chain of command down the structure
- **Reporting structure** Who reports to whom
- **Silo** Pejorative term for a department that works in isolation: a vertical, closed structure, like a grain silo

Divisional structure

Some companies arrange their staff into divisions devoted to a specific product or market. Each division is a self-sufficient team employing the personnel for the various functions within it.

How it works

Under the overall control of a CEO or president, several divisions work alongside one another to design, research, produce, and sell a particular product or to service a specific market. Each division runs its own specialized functions, such as operations or sales, although some, such as finance, may remain centralized to save on costs. A company may arrange its divisions according to the types of product it makes, the regions in which it operates, or the customers to whom it sells. Large companies may adopt hybrid structures—by product and geography, for example.

DIVISIONAL: PROS AND CONS

Pros

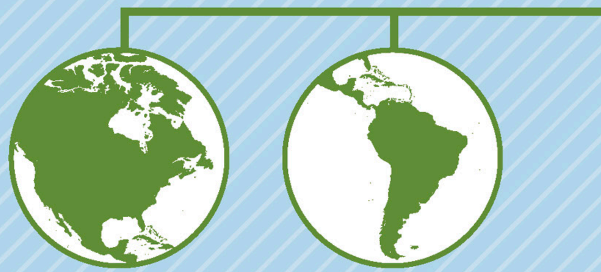
- If one division fails, there is no threat to the rest of the business
- Can respond quickly to changes in the market
- Focused on customer needs
- Performance of each division clearly measurable

Cons

- Duplicating resources—for example, each division employing finance personnel
- Lack of expertise-sharing between divisions
- Career path for staff restricted
- Heightened sense of competition among divisions

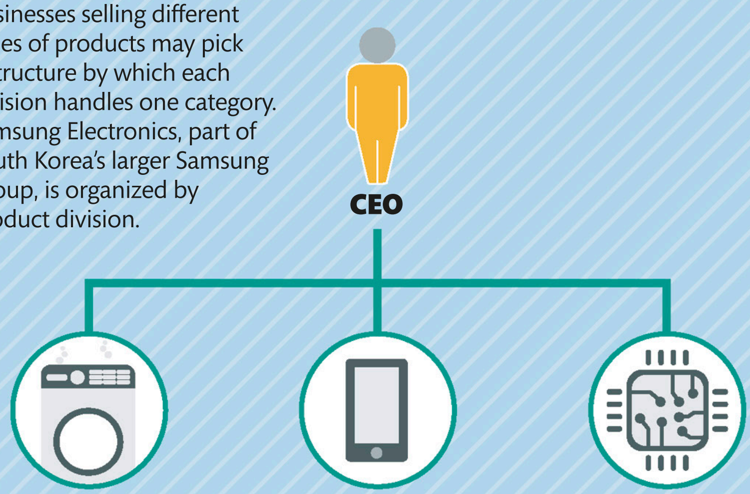
Division by geography

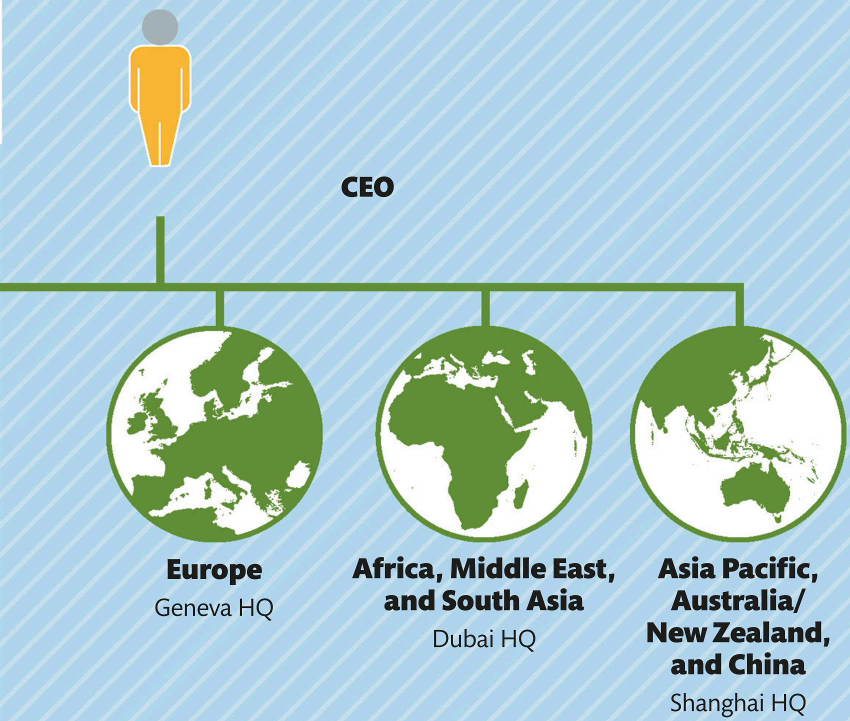
For businesses with products that need to be adapted to local markets, an organization can be structured according to each of the regional markets it serves. These may be domestic or international. Food and drink corporation PepsiCo broadly follows this structure, with seven divisions serving five regions (*see case study, right*).



Division by product

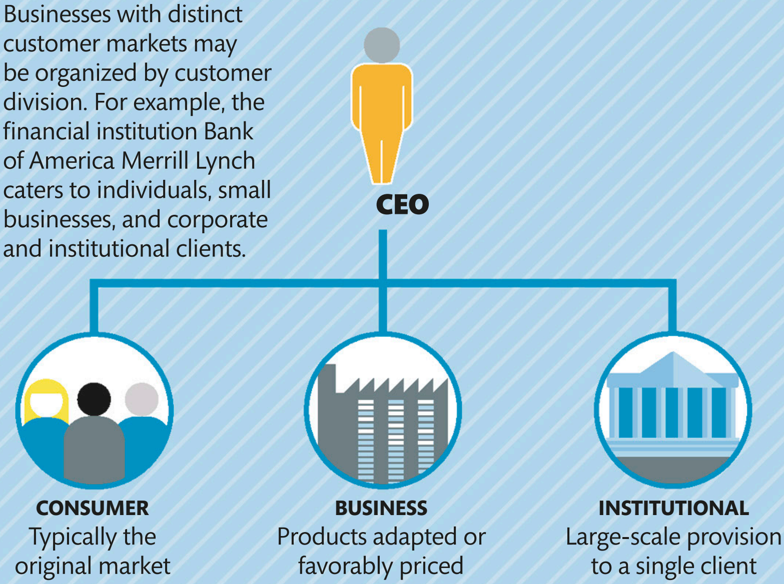
Businesses selling different types of products may pick a structure by which each division handles one category. Samsung Electronics, part of South Korea's larger Samsung Group, is organized by product division.





Division by customer type

Businesses with distinct customer markets may be organized by customer division. For example, the financial institution Bank of America Merrill Lynch caters to individuals, small businesses, and corporate and institutional clients.



CASE STUDY

PepsiCo

Food and beverage company PepsiCo's global operations have undergone various transformations over the decades, as it has acquired new brands and expanded around the world. Today, it comprises seven divisions in a hybrid structure arranged by product and geography.

Three divisions are in North America—PepsiCo Beverages North America (drinks), Frito-Lay North America (snacks), and Quaker Foods North America (cereals and snacks)—while the remainder look after both food and drink products in four global regions.

This allows those making the decisions about popular local brands—including Walkers in the U.K. and Pioneer Foods in South Africa—to be close to the customers who buy them.

$6.9 billion in net revenue generated by PepsiCo Latin America in 2020

Matrix structure

Unlike a conventional company hierarchy organized either by function or division, a matrix combines the two approaches so that staff work in functional and divisional units and report to two bosses.

How it works

A business that uses a matrix setup often begins with the more traditional functional structure. As the business develops, it may make sense to overlay a divisional structure to meet changes in business conditions—for example, if a company is managing several large projects for a client or expands globally and is selling its products in several regions. A matrix grid may start out as temporary—perhaps formed to manage short-term projects—and become permanent.

The two chains of command in a matrix create the grid. Staff report along a vertical line to a functional manager, such as the marketing director, and along a horizontal line to the project manager of a specific business line, brand, project, or region.

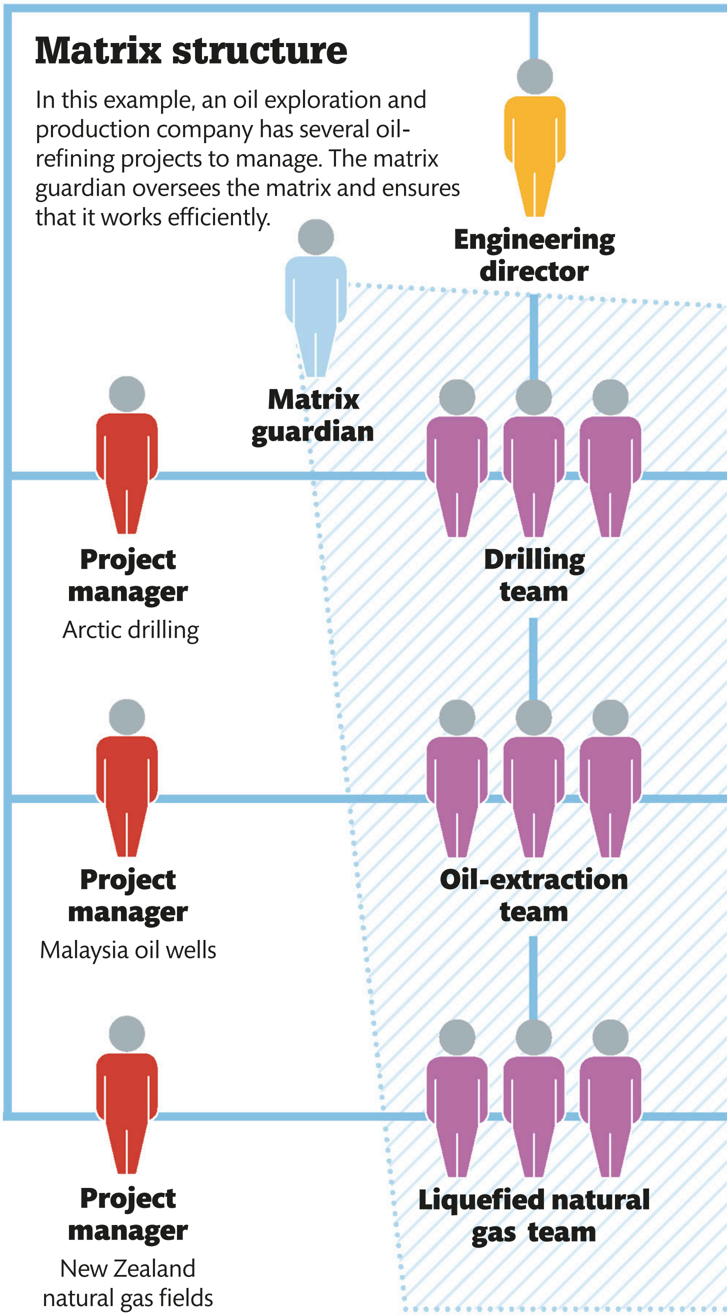
FOUR BIG MATRIX ORGANIZATIONS

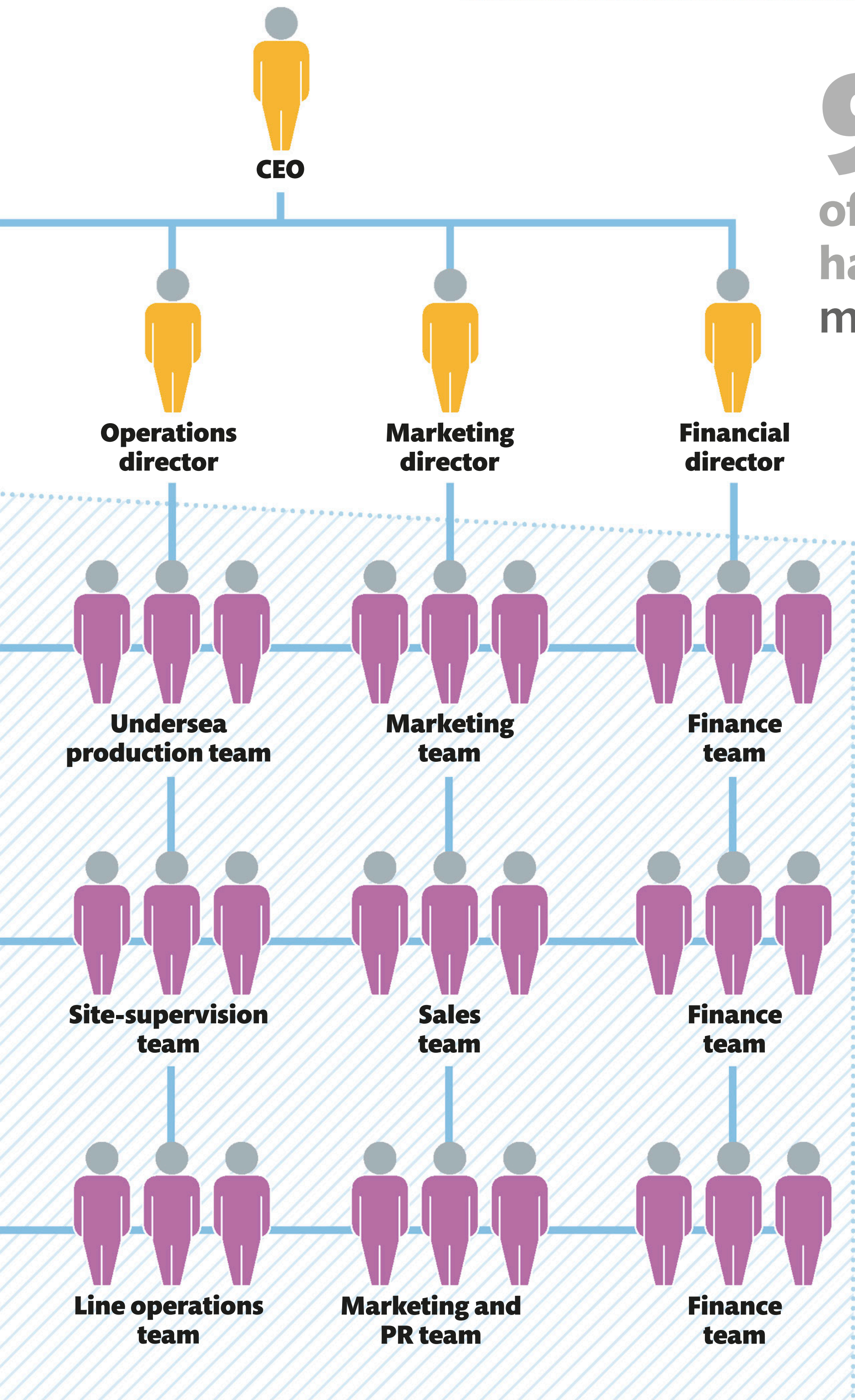
Each of the following companies has been cited as a model for making the matrix structure work:

- **Procter & Gamble (P&G)** To help it innovate and respond faster to the market, the consumer-product company is segmented into baby and feminine care, beauty, family care and P&G ventures, health care, grooming, and fabric and home care.
- **Nestlé** The Swiss conglomerate is managed by geographical divisions across most of its food and drink business, although some product-centered businesses, including Nespresso and Nestlé Health Science, are managed globally.
- **Sony** The Japanese media, tech, and financial services conglomerate is primarily organized around business-/product-type divisions and function-based groups, such as research and development, although it also uses geographic divisions. This flexible structure allows it to effectively address market challenges.
- **Starbucks** The global coffee-shop chain is arranged by product, geographic, and business function divisions to ensure that quality and innovation meet customers' expectations and anticipate their desires.

Matrix structure

In this example, an oil exploration and production company has several oil-refining projects to manage. The matrix guardian oversees the matrix and ensures that it works efficiently.





90% of top multinationals have adopted a matrix structure.

NEED TO KNOW

- **Matrix guardian** Senior professional appointed to oversee the matrix and make sure that it works efficiently
- **Mature matrix** Matrix structure in which functional and divisional bosses have equal power
- **Solid-line reporting** A direct reporting relationship between a worker and primary supervisor
- **Dotted-line reporting** A more indirect reporting relationship with a secondary supervisor

MATRIX: PROS AND CONS

Pros

- Faster decision making
- Potential for improved productivity
- Flexible use of staff

Cons

- Expensive to set up and run
- Possible confusion regarding the reporting line
- More potential for interpersonal conflict as team goals conflict

Network structure

Also called a virtual organization or virtual corporation, a network structure is centered on a streamlined company, with digital connections linking it to external, independent businesses.

How it works

The company at the center of the structure is stripped back to basic functions that are essential to the type of business being operated—research and development, for example, in the case of a technology company. All other functions are outsourced to external specialists. The various parties often work remotely around the globe and are connected by the internet. Together, they provide all the services needed for the network to function as one entity. This type of business structure is based on the idea of the social media network and is therefore known as a network enterprise.

NEED TO KNOW

- **Agile business** Term to describe a networked organization; the opposite of a traditional bureaucracy
- **Decentralized** Organization with a wide span of control and often an upward flow of ideas

Network structure in practice

A small film production company based in Los Angeles is operating from a studio space with two employees—a producer and an assistant. For each project, the producer connects with outsourced talent around the world, and everyone collaborates to create the finished film. The producer contracts and pays these external suppliers.

VARIATION: MODULAR STRUCTURE

In a business with a modular structure, parts of a single product are outsourced (functions or processes, not products, are outsourced in a network structure). A modular structure is especially suitable for organizations producing appliances, computers, cars, and mechanical consumer goods. Toyota is an example of a company with a modular structure, managing hundreds of external suppliers to produce its finished vehicles.

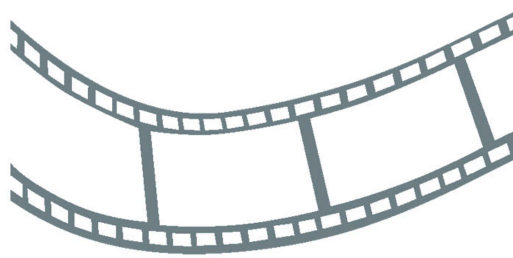
Pros

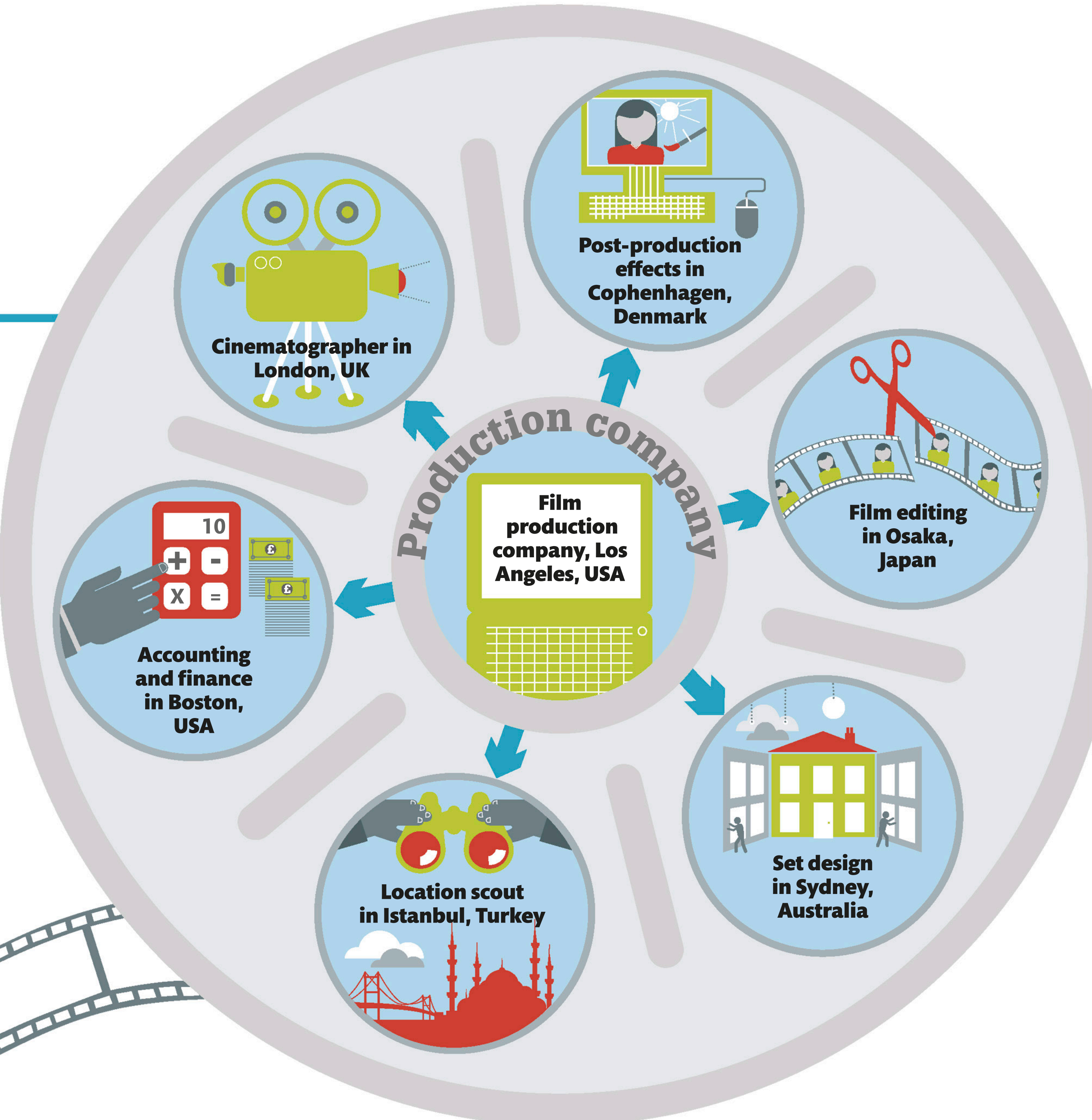
- Potential for round-the-clock work because of global locations
- Can source the best expertise wherever it is in the world
- Low overhead, as there are minimal staff in the core company
- Can develop a flexible and highly creative environment

Cons

- Extreme reliance on technology means that network errors can stop effective performance of the business
- Potential for less control and missed deadlines
- Difficult to find common time across different time zones for virtual meetings

27% of networked organizations report higher profit margins than their competitors.




Production company
Film production company, Los Angeles, USA
Cinematographer in London, UK
Post-production effects in Cophenhagen, Denmark
Film editing in Osaka, Japan
Set design in Sydney, Australia
Location scout in Istanbul, Turkey
Accounting and finance in Boston, USA
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Team-based structure

As its name implies, a team-based organization (TBO) is made up entirely of teams. Managers and staff from different departments join to form teams handling specific projects in the short or long term.

How it works

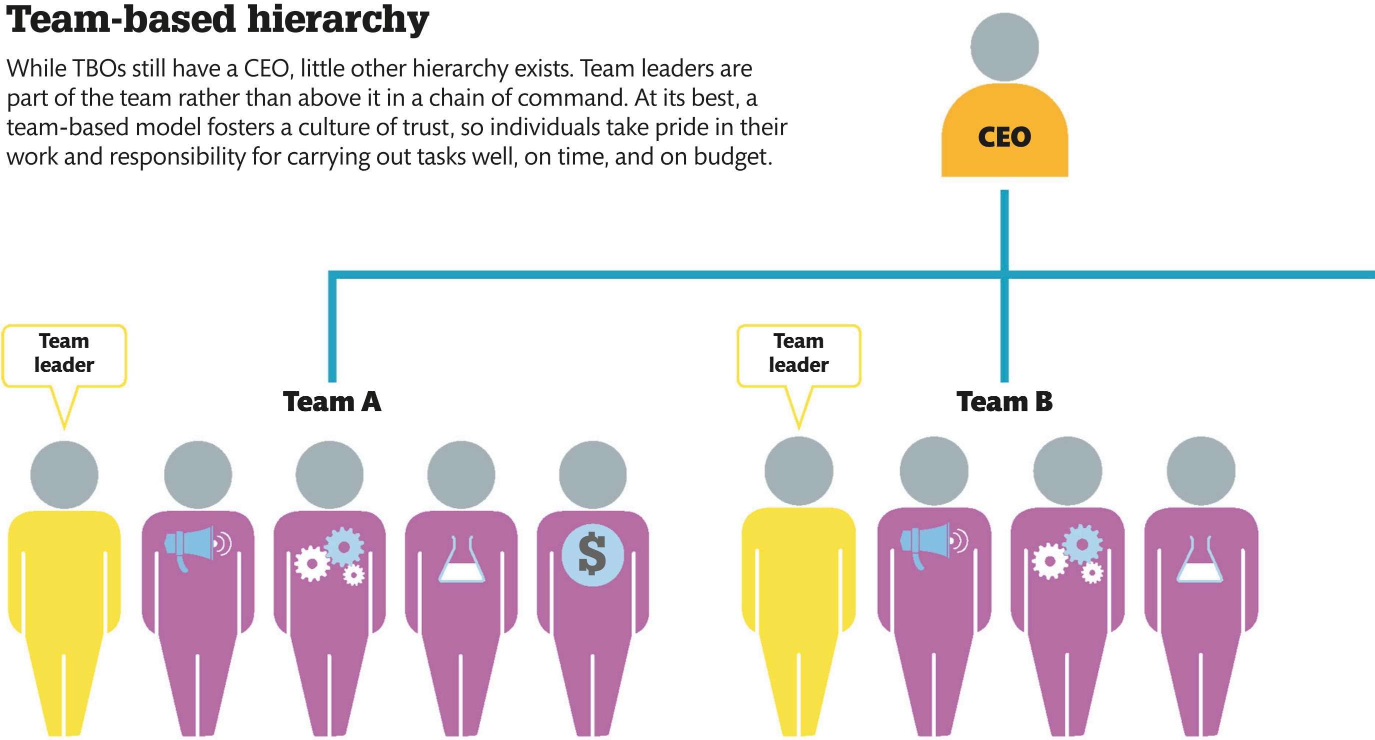
In a TBO, teams reach decisions through brainstorming and mutual agreement among team members rather than from a senior management member issuing orders from the top of the chain of command, as in a traditional organizational structure.
Communication is less formal in TBOs, often carried out using messaging apps and social media as well as online collaboration tools, such as Slack, and video conferencing software, including Zoom and Microsoft Teams.
One step beyond the team-based structure is a Holacracy (*see box, right*), an unconventional type of organization in which there are no managers and even the CEO relinquishes power, allowing employees to self-govern through regular committee meetings, which they organize themselves.

NEED TO KNOW

- **Cascading** Successful passing of information or objectives down through the workforce
- **Lateral structure** Decentralized structure in which departments work to a common goal
- **Flat lattice** Structure with no chains of command, in which workers choose to follow leaders

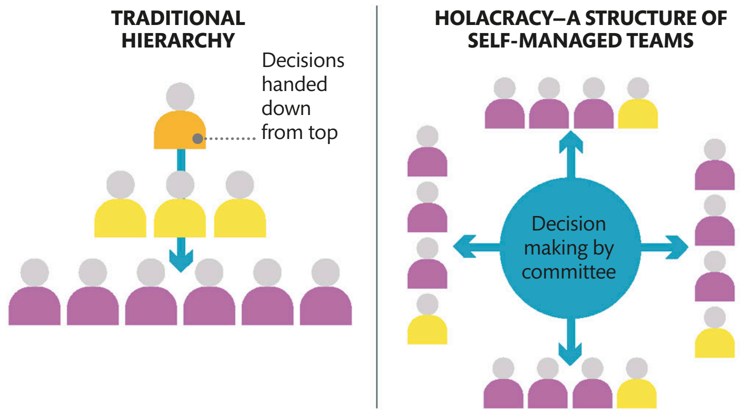
Team-based hierarchy

While TBOs still have a CEO, little other hierarchy exists. Team leaders are part of the team rather than above it in a chain of command. At its best, a team-based model fosters a culture of trust, so individuals take pride in their work and responsibility for carrying out tasks well, on time, and on budget.

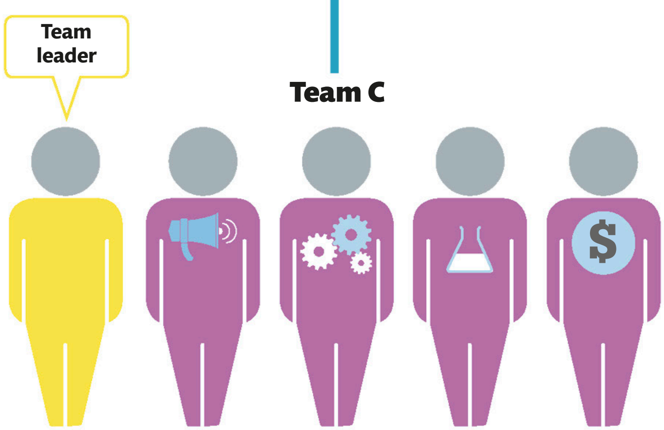


HOLACRACY—BREAKING BOUNDARIES

In a Holacracy, staff are grouped into teams that set their own roles and goals and choose their own leaders. The idea is that if power and responsibility are shared, employees will give their very best. In 2014, the Las Vegas-based online shoe and clothing shop Zappos adopted the model for its 1,500 staff. The term “Holacracy” is a trademark of HolacracyOne, the company spearheading the adoption of the management system. It follows the same principle as a flat lattice but takes the idea one step further by presenting a comprehensive management structure with clear processes for internal operations and governance.



74% of global organizations have seen improvements in performance since switching to a team-based structure.



TEAM-BASED: PROS AND CONS

Pros

- Quick decision making and rapid response to problems and challenges
- Reduced overhead, as there is no heavy management structure
- Open communication, as there is no fear of management reaction

Cons

- If staff lack expertise, decisions may be flawed
- Limited sharing between teams may affect business performance
- Decisions by consensus are harder to reach

Human resources

The human resources (HR) department is responsible for all policies and processes relating to the people employed by a business. To help the business achieve its goals, HR has to make sure it employs a diversity of people with the right skills, irrespective of their gender, race, or faith. It must treat them consistently and fairly, providing a framework to look after their well-being, supply training, and foster their progress.

HR framework

The starting point for any decision in an organization is its business goals. HR supports the delivery of these goals by ensuring that there is a staffing strategy to support the business plan. Typically, an HR framework sets out a people strategy, including the competencies of the people who best suit the organization. This is then implemented in a range of areas, from recruitment and selection to learning and development. Diversity and inclusion (D&I) is increasingly important, with companies that have higher levels of gender, ethnic, and cultural diversity consistently performing better. HR professionals work closely with business leaders and line managers to design and implement HR systems that support strategic business goals.

36%
more profitability is achieved by the most ethnically and culturally diverse companies.

ESSENTIAL PEOPLE SKILLS

As well as recruiting effectively and ensuring that employees deliver, HR plays a role in nurturing essential people skills across the organization.

Relating to others

- Some people are natural leaders, but most leaders can benefit from objective thinking about the leadership strategy they wish to follow. *See pp.88–89.*
- Even in flattened, team-based hierarchies, team leaders need to develop leadership skills to guide and support their teams. *See pp.90–91.*
- Despite the revolution in technology, people remain vital to organizations, as skills and knowledge are central to success. As a result, HR has an expanding role. One example is Google, which calls its HR function People Operations (POPS) and treats its staff as a valuable asset, offering a range of attractive perks to "find them, grow them, and keep them." *See pp.92–93.*

Managing projects

- Project management is an essential skill for managers at all levels, whether they are running regular day-to-day activities or special projects. *See pp.94–95.*

Negotiating

- The ability to negotiate successfully is an essential skill. Awareness of strategies and styles is key to success. *See pp.96–97.*

The human resources cycle

From the moment a company starts to recruit an employee to the time that person leaves the company, the individual is in a cycle that is managed by the human resources (HR) department.

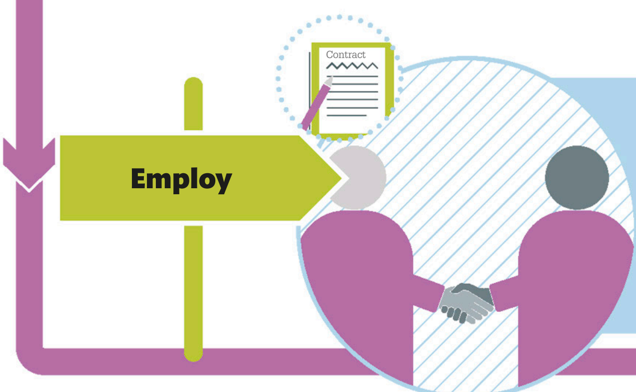
How it works

People are a significant cost to any organization and of great value—both those who work on the premises and those who work remotely. Many CEOs talk about staff as their most important business asset, and industrialist Henry Ford famously said: "You can take my factories, burn up my buildings, but give me my people, and I'll build the business right back again." The HR department is there to ensure that the right people are in the right roles so that the company can deliver the business strategy and maintain its competitive edge. The complexity of the business influences the stages in the HR cycle, but the basic elements are the same.

NATIONAL EMPLOYMENT LAWS

Employment practice is regulated by legislation covering everything from gender and racial discrimination to time-off entitlement and dismissal. Laws that once only applied to full-time staff are being increasingly extended to part-time workers and those on contracts.

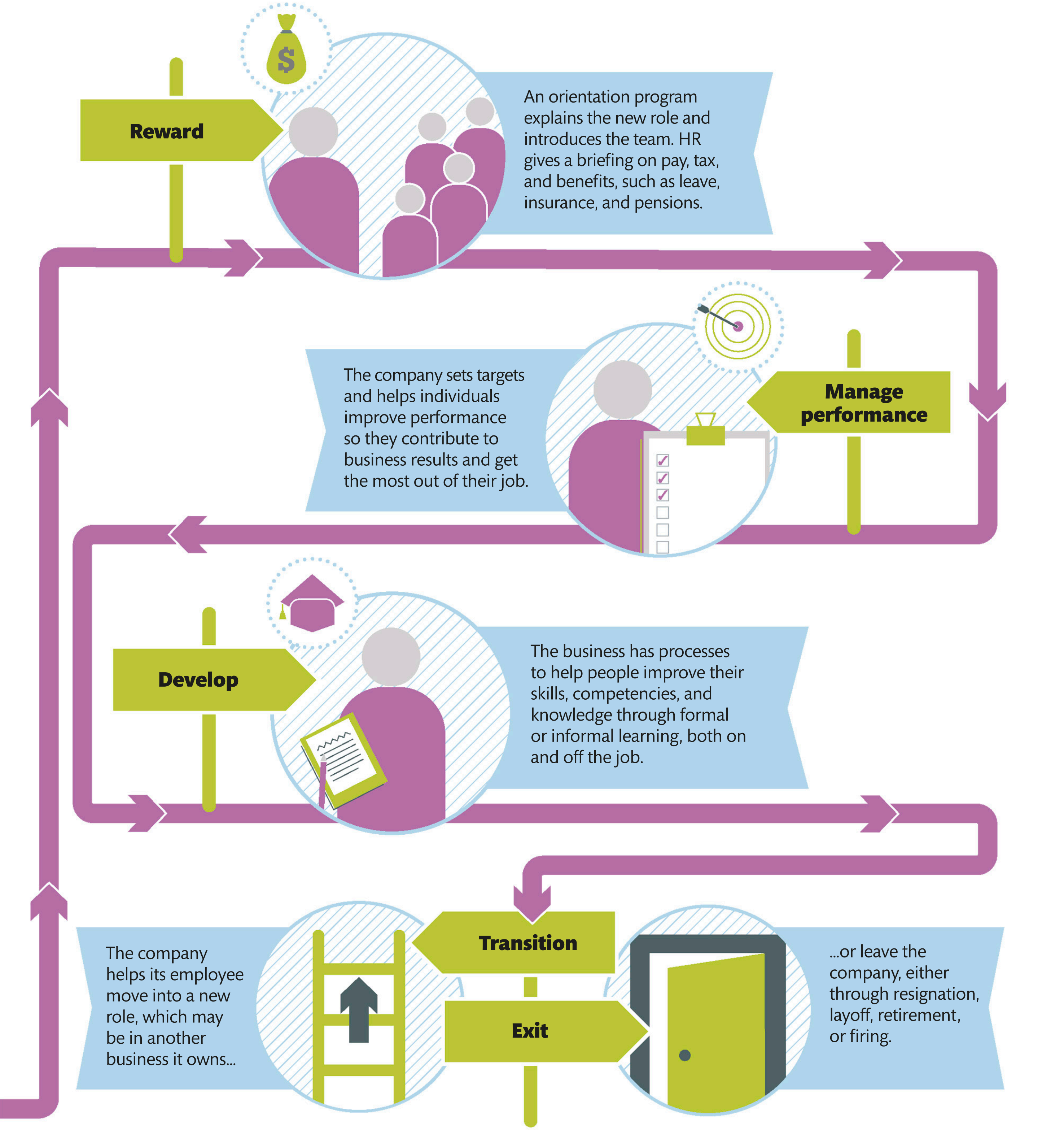
A business identifies the need to fill a role and attracts applicants. Résumés are assessed and interviews held to find the best candidate.



Once terms are settled and a contract signed, the candidate becomes the company's employee.

"Hire people smarter than you and get out of their way."

Howard Schultz, *former Starbucks CEO*


Reward
An orientation program explains the new role and introduces the team. HR gives a briefing on pay, tax, and benefits, such as leave, insurance, and pensions.
Manage performance
The company sets targets and helps individuals improve performance so they contribute to business results and get the most out of their job.
Develop
The business has processes to help people improve their skills, competencies, and knowledge through formal or informal learning, both on and off the job.
Transition
Exit
The company helps its employee move into a new role, which may be in another business it owns...
...or leave the company, either through resignation, layoff, retirement, or firing.

Recruitment and selection

Placing the right person in the right job is vital for the success of the organization—this is the process of recruitment and selection. Technology is changing traditional hiring pathways.

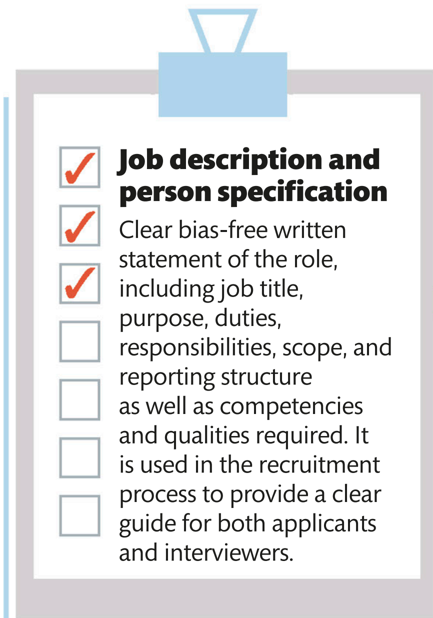
How it works

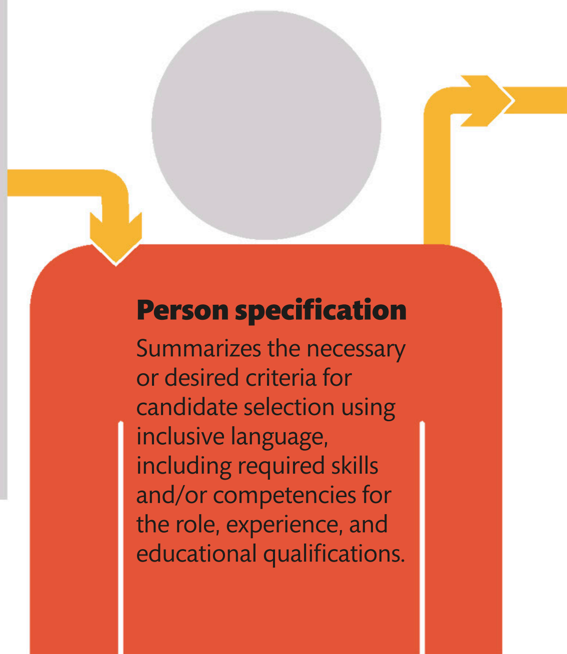
Human resources and line managers usually work together to organize the process of recruitment and selection. Recruitment starts with the company identifying a vacancy—the need for someone to do a job and pulling together information about the exact nature of the role and the skills, abilities, and experience required to do it. Aspects to consider include the job's purpose, tasks required, and the outputs or deliverables of the job holder as well as how the role fits into the organization's structure. This information forms the basis of a job description and person specification. The search can then begin. The company's own website, recruitment agencies, social media, networking sites, commercial job boards, and advertisements in the press are traditional ways of attracting the attention of people outside the organization. Today, application forms are typically directly submitted online, triggering automatic responses and sorting of candidate details.

BOOSTING DIVERSITY

A diversity and inclusion (D&I) strategy is an essential part of any HR framework. Recruiting from a range of backgrounds, regardless of gender, race, culture, and age, and making all staff feel safe and included in the workplace helps firms innovate, connect to more customers, and get the most out of their workforce, ultimately leading to higher profits. Casting a wide recruitment net, communicating D&I commitments, assessing candidates' competencies over skill sets and experience, removing bias in the selection process, and providing D&I training can all help boost company diversity.

3 people are hired every minute on professional networking website LinkedIn.





Internal search
Looking at internal resources first creates opportunities for career development and progression, improving employee engagement and retention.

Personal recommendation
Some companies encourage existing employees to introduce friends as candidates.

External search
Increasingly, companies and candidates use professional networking sites,such as LinkedIn, and social media, such as Facebook or Twitter. External candidates diversify the workforce but cost more to attract.

Applications
The résumé is the most important document, often paired with a cover letter. Companies may use an application form instead.

NEED TO KNOW

- **Psychometric tests** Often used as an initial screening method, these aim to assess such attributes as intelligence, aptitude, and type of personality, using verbal and nonverbal reasoning tests and behavior questionnaires.

Selection
After HR has drawn up a shortlist using nondiscriminatory criteria, candidates may be assessed by interviews, group assessment, and psychometric testing, either online or in person.

CONTRACT

Appointment
Companies may ask for references and/or request a medical examination for the chosen candidate. The employment offer is a legally binding contract that sets out the terms and conditions of the job.

Evaluating staff

For a business to achieve its goals, it needs to have a process that measures the contribution and performance of each individual against those goals.

How it works

The way in which tasks are done is becoming as important as what tasks are done, as organizations recognize the importance of creating the right culture to enable workers' performance. For any company, effective evaluation of the performance of employees should be strategic and aimed at ensuring the maximum productivity of individuals, teams, and the organization as a whole.

Traditional performance-management cycle

Performance management is an ongoing, continuous process. Many companies use "360-degree feedback" to collect information about an employee's performance anonymously from a range of people, including their boss, colleagues, customers, and staff members.

A WIN-WIN SITUATION

Evaluating performance is good for both the business and the individual.

Business

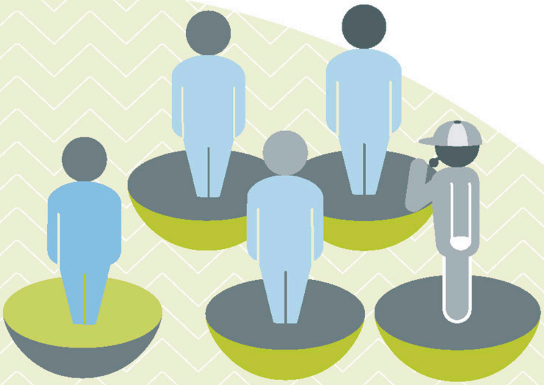
- Aligns individual goals with company goals.
- Offers consistent approach, with benchmarks.
- Continuously enables improvement.
- Fosters the right behaviors and relationships.

Individual

- Understands what is expected of them.
- Has the skills to deliver on these expectations.
- Is supported to fill any gaps in capability.
- Is given feedback and allowed to discuss goals.

UNCONSCIOUS BIAS

Companies should be aware of the role unconscious bias can play in performance appraisals. An appraiser's subconscious prejudices about employees' race, gender, age, class, sexuality, or disability can cause talented individuals to repeatedly be denied promotion or have their attitude questioned. Conduct unconscious bias training to make staff more aware of the issue and require appraisers to use objective criteria to identify job competencies and to justify their appraisal scores with evidence.



2

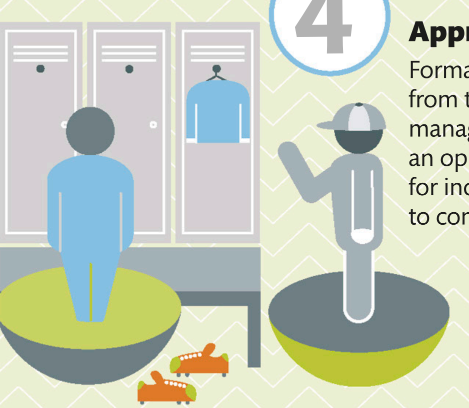
Discussion
Ongoing communication on standards of work and behavior to improve working relationships

3

Coaching
Discussion of performance issues and ways to tackle challenges

4

Appraisal
Formal feedback from the direct manager, with an opportunity for individuals to contribute



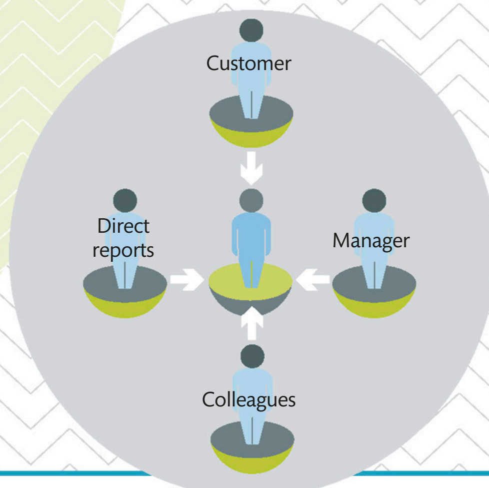
INPUT FROM COLLEAGUES

✓ NEED TO KNOW

- **Balanced scorecard** Framework to measure performance against strategic goals, devised by Kaplan and Norton
- **Competencies** Defined behaviors and attributes that individuals must have to perform effectively at work
- **Performance appraisal** Process via which individual employee and their manager can discuss performance and development

360-degree feedback

Gives a rounded picture with better information about working relationships



Motivation and rewards

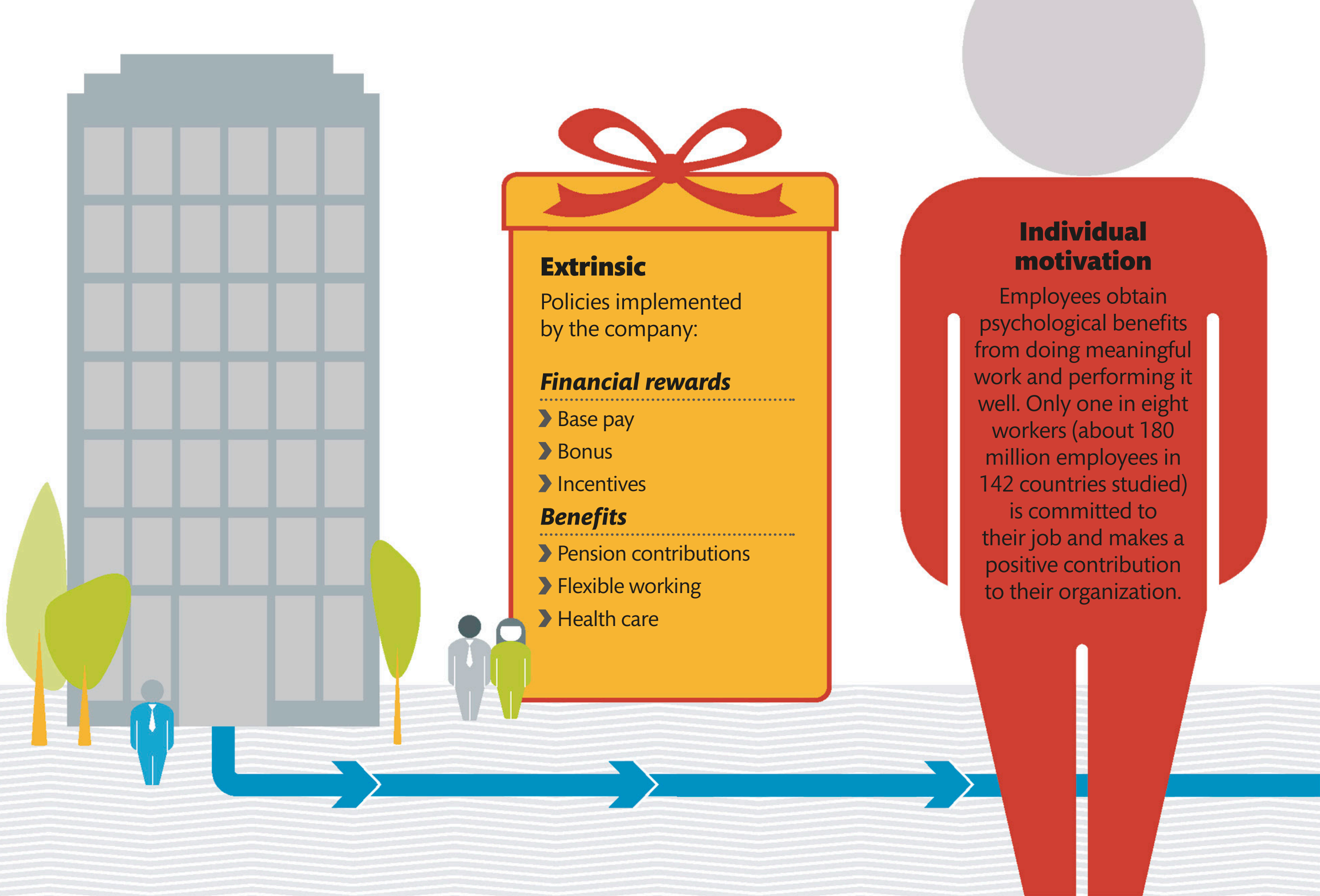
People work for money, but they are also motivated by other factors, such as doing a good job and being valued. Nonfinancial rewards drive day-to-day motivation more strongly than pay and benefits.

How it works

In the past, tangible pay and benefits were the key motivational tools for employees. These financial rewards are termed "extrinsic" because they are external to the actual work, and others control the amount, distribution, and timing. Employers now recognize that while extrinsic incentives are clearly important, intrinsic (psychological) rewards are crucial.

Understanding motivation in the workplace

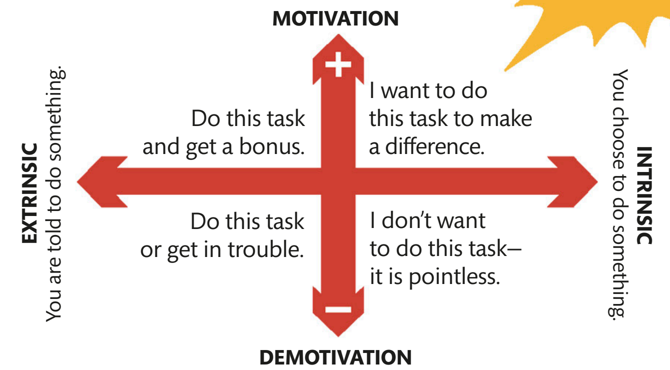
Happy staff work well, and job satisfaction comes from subtle feel-good factors as much as a paycheck. Employees who enjoy their work tend to stay—job satisfaction makes for lower staff turnover.



15% of employees around the world are fully committed to their jobs.

WHY PEOPLE DO TASKS

Only this creates positive motivation.



Intrinsic

Feelings that an individual has:

- **Purpose** A sense of being able to accomplish something of value
- **Choice** Clear ownership and feeling responsible for outcome
- **Progress** As an individual, feeling and seeing evidence of moving things forward
- **Competence** Pride and satisfaction in own work

Fostering intrinsic rewards

Businesses that are successful engender trust and therefore have employees who are passionate about what they do. All these factors contribute:

Purpose for organization and individual

- Clear vision for organization
- Understanding of where individual fits to achieve that purpose
- Clear goals and expectations for individual

Recognition

- Continuous feedback
- Ongoing engagement
- Noncash rewards, such as praise

Career development

- Progression and promotion
- Mentoring and coaching
- Learning opportunities

Culture

- Strong teamwork and consistent behaviors
- Open communication
- Sharing of knowledge and information

INCREASING MOTIVATION

Leadership strategy and styles

Top-down leadership, in which managers give orders, is not always the best way to get results. A number of different leadership styles have been identified by business experts.

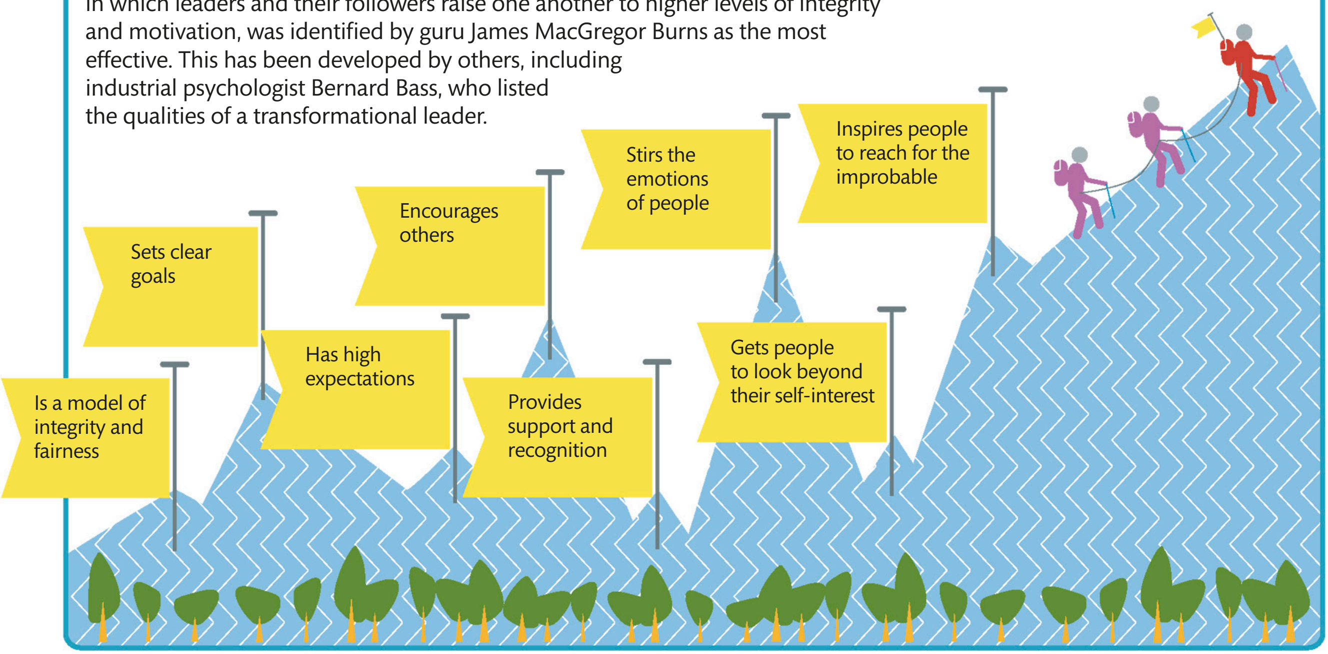
How it works

Every leader is an individual with their own approach. However, over the years, management gurus have identified key leadership styles that can be used to achieve different results, depending on the environment. Many frameworks are based on the ideas of psychologist Kurt Lewin, who developed his theories in the 1930s with three major styles: autocratic, democratic, and laissez-faire (noninterference). In 2007, for example, business authors Eric Flamholtz and Yvonne Randle developed a leadership matrix based on Lewin's theories, which shows the best style to use in any given situation, ranging from autocratic (one all-powerful leader) to consensus (decisions reached by general agreement). Truly inspirational leaders encourage people to believe in themselves so that they achieve results beyond even their own expectations.

> "Outstanding leaders go out of their way to boost the self-esteem of their personnel."
>
> Sam Walton, *Walmart founder*

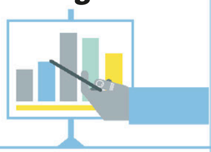
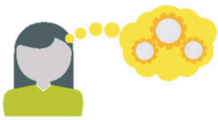
TRANSFORMATIONAL LEADERSHIP

While different styles can suit different situations, transformational leadership, in which leaders and their followers raise one another to higher levels of integrity and motivation, was identified by guru James MacGregor Burns as the most effective. This has been developed by others, including industrial psychologist Bernard Bass, who listed the qualities of a transformational leader.



When to use which leadership style

A three-year study of 3,000 managers led psychologist Daniel Goleman to identify six distinctive styles of leadership. Each style has a significant impact on how people feel about their work. The most effective leaders master a number of styles and use them appropriately, according to the situation.

	Style	When to use	Drawbacks
Affiliative 	**"People come before task."** Focuses on creating emotional bonds within a team and a sense of belonging within an organization.	Use in times of stress, when teammates need to recover from trauma, or when the team needs to rebuild trust.	Praise and nurturing can foster mediocre performance and lack of direction.
Coaching 	**"Try this."** Helps people find their strengths and weaknesses, linking these to career aspirations and action.	Use to help teammates build lasting personal strengths that make them more successful.	Coaching is ineffective when teammates are defiant and/or unwilling to change or learn or if a leader lacks ability.
Commanding/ coercive 	**"Do what I tell you."** Demands immediate compliance, without discussion or negotiation.	Only use in times of crisis or to control problem employee when all else fails.	Insistence should only be used when essential; it can alienate people, stifle inventiveness/flexibility, and tauten atmosphere.
Democratic 	**"What do you think?"** Aims to build consensus through participation.	Use when it is necessary for the team to buy into or have ownership of a decision, plan, or goal.	This is not for use in crisis or when teammates are not well enough informed to be able to offer suitable guidance to the leader.
Pace-setting 	**"Do as I do, now."** Expects and models excellence, creating challenging and exciting goals for the team.	Only use when the team is already motivated and competent and when fast results are necessary.	Style can overwhelm some team members and adversely affect employee commitment; it may stifle creativity and innovation.
Visionary/ authoritative 	**"Come with me."** Mobilizes the team toward a common vision and goal, leaving the means up to the individual.	Use when the team needs a new vision because circumstances have changed or when explicit guidance is not required.	This is not effective when a leader is working with a team of experts or better-informed group.

Leadership for team building

Just as generals have to get the best from their troops, so business leaders must make the most of their teams. The key is ensuring that individuals work together to achieve a common goal.

How it works

From statesmen, such as former British prime minister Winston Churchill, to Facebook executive Sheryl Sandberg, great leaders recognize that to achieve a long-term goal, they must not only use their own capabilities but also maximize the combined strength of other people. They have a passion that sweeps people along with them; they learn from mistakes and are prepared to change course to face evolving circumstances. Much academic work has been done to study the traits and strategies of such leaders.

How leaders inspire their teams

Academic Carl Larson and organizational effectiveness expert Frank LaFasto conducted a three-year study of more than 75 diverse teams. They identified six characteristics of leadership that steer a team toward optimum results.

Focusing on goal

- Defines goal in clear and inspirational way
- Helps each team member see how they contribute to goal
- Does not play politics

Encouraging collaboration

- Allows open discussions
- Demands and rewards collaboration
- Involves and engages people

Building confidence

- Accentuates the positive
- Shows trust by assigning responsibility
- Says "thank you"

> "Leadership is the art of getting someone else to do something you want done because he wants to do it."

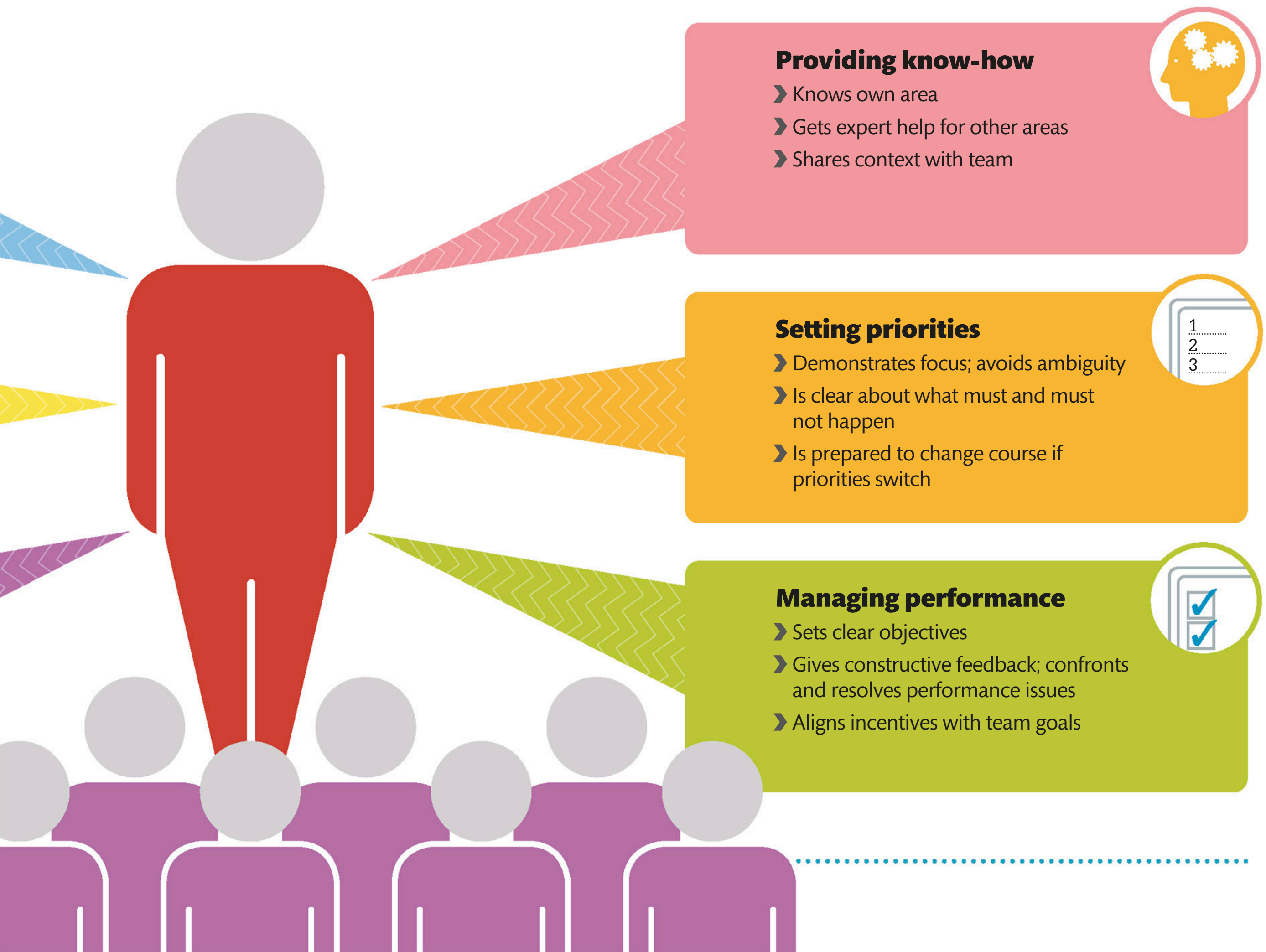
Dwight D. Eisenhower,
former US president

BUILDING AN EFFECTIVE TEAM

In their book *The Wisdom of Teams* (1993), Jon Katzenbach and Douglas Smith make a distinction between teams and ordinary groups of people who work together. They define a team as "a small number of people with complementary skills who are committed to a common purpose, set of performance goals, and approach for which they hold themselves mutually accountable." They found that leaders who manage to build successful teams tend to:

- Select members for skill and potential, not personality.
- Focus on a few immediate tasks and goals at the beginning to help the team to bond.
- Set boundaries and behavioral norms.
- Stimulate the team regularly with new information, encouraging open discussions and active problem solving.
- Ensure that the team spends lots of time together, both in and outside work.

> **"Don't find fault—find a remedy"**
>
> **Henry Ford,**
> ***US industrialist***



Employee relations and communications

Thriving organizations recognize the importance of using people's ideas and energy to provide a competitive edge, while managers are eager to gain, retain, and build employee commitment.

How it works

Whether managed by human resources (HR) or as a function in their own right, employee relations and communications are increasingly sophisticated. Rather than just relying on face-to-face talks and word of mouth, successful firms use a range of communication tools to help people understand the business goals and their contribution to results. In particular, leaders no longer send only one-way messages but use interactive media, such as video conferencing. In turn, this has paved the way for effective remote working. Workers can use intranets and online collaboration tools, such as Slack, to share knowledge, but they may still opt to meet in formal settings, such as committee meetings and forums.

The art of communication

In this example, a company is establishing weekly employee forums to facilitate communication and build trust throughout the business. To strengthen employee awareness, engagement, and commitment to the idea, various media are used, from email to webinars and discussion. Managers increasingly focus on collaboration rather than just impart information.

EMPLOYEE FORUMS

In many countries, employee communication used to focus on structured industrial relations, managed by HR. Employee relations are now based more on trust and building strong relationships. Many firms create formal work committees or employee forums.

At their best, employee forums:

- Allow representatives from across the business to share and generate ideas for improving performance.
- Encourage discussions on visions, changes, and plans for business.
- Recognize the value of employees.

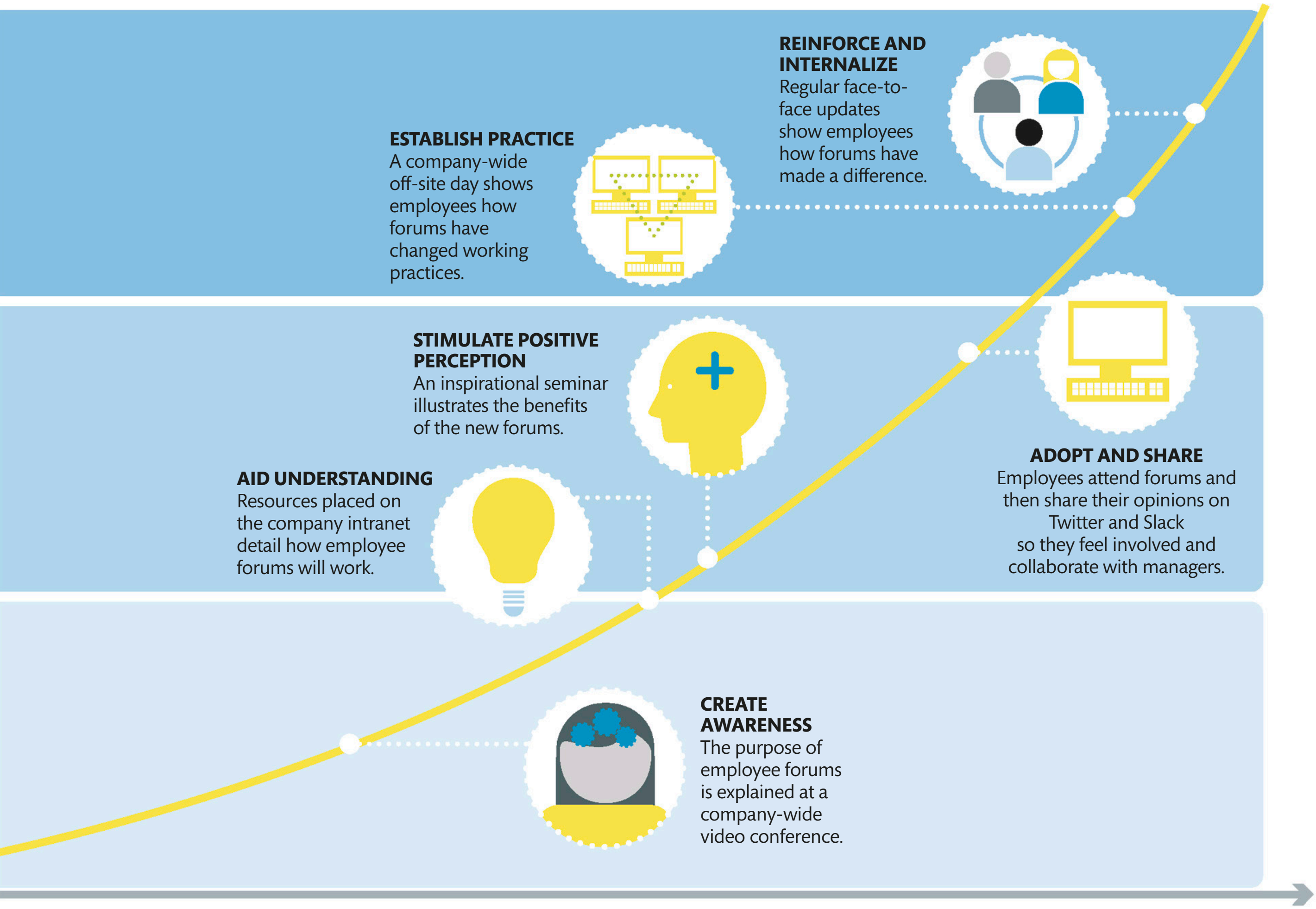
CASE STUDY

John Lewis

The John Lewis chain of department stores in the UK is famous for its unique employee-owned structure, in which every worker is a partner in the business. It has a number of employee-communication policies:

- **Gazette** Employees can send letters directly to management through the weekly gazette. Managers publish their responses in the gazette for all to read.
- **Partnership council** Made up of 58 elected partners from across the business, the council meets several times a year. The chair and directors report to the council, which can remove the chair.
- **Forums** Elected by employees on a three-year basis, forum representatives serve to reflect the views of the partners in a specific region, community, or business area.

£1.5 billion spent on basic pay by John Lewis in 2020–2021



Project management

Besides day-to-day activities, a business may have projects—one-off, specific pieces of work. Projects need to be well managed so they deliver the benefits that they were designed to achieve, on time and on budget.

How it works

The process of project management takes a complex project from start to finish. It requires a different set of knowledge, experience, and skills from a mainstream operation because the goals set up have to be achieved within defined limitations. These constraints include scope, time, quality, and budget. A project team might include people from different organizations, diverse disciplines, and multiple locations. Successful project management involves not only overseeing the people working toward the particular objective but also managing the risks, schedule, relationships, individual and team input, range of stakeholders with a vested interests in the project, and financial resources.

Effective project management is increasingly viewed as a strategic competence (*see p.85*) for any business because it enables the introduction of new products, new methods, and new technology.

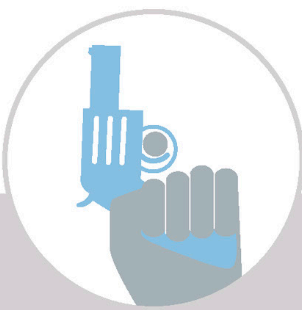
✓ NEED TO KNOW

Project management tools

There are many different project management tools, with each suiting certain types of project and skill levels better than others. Specialist software, such as Wrike and LiquidPlanner, offer powerful feature sets, while more user-friendly tools, such as Trello, are good for simpler projects.

Steps in project management

There are many workable project management systems, using various definitions for the key stages, all of which are encompassed in five main elements.



Initiation

- Project charter, including business case, objective, scope, budget, deliverables, and schedule
- Roles and responsibilities
- Resource allocation

Planning

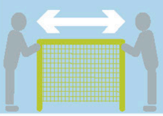
- Detailed plan of work
- Critical path analysis
- Risks

Execution

- Coordinating people and resources
- Quality assurance
- Communication to team and stakeholders

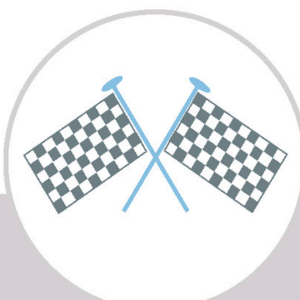
HURDLES AND HOW TO OVERCOME THEM

Every project comes up against challenges. These are some of the common ones and the ways that effective management can keep the project on track.

Obstacle	Project managment	Options
 **Project is not on schedule or is running short of time**	› Map out timeline of work and critical paths using tools and techniques. › Review remaining work and identify risks, barriers, and mitigating strategies.	› Negotiate scope, budget, and resources of the project. › Inform other teams and see if any changes can be factored in.
 **Unclear vision or lack of clarity**	› Review project charter and revisit vision and objective. › Involve team so everyone understands direction of work and avoids stalling.	› Seek clarity from sponsors and/or senior management.
 **Scope creep –project changes once under way**	› Manage requests for change against business case and project objective.	› Communicate to identify why change is important and how to incorporate or find alternative.

Monitoring and control

- Measuring effort and progress
- Managing and mitigating risk
- People management



Closure

- Finalizing all activities
- Communication
- Learning–project review

97% of managers from 38 countries believe project management is critical to success

Negotiating strategy

Skillful negotiation is vital in business when two or more sides have different viewpoints, and each one wants to press for their own advantage. The ideal outcome is a compromise that delivers the best results for both.

How it works

Like many aspects of business, negotiation is a process to find a mutually acceptable solution. Before any discussion, each party must work to understand the other's interests and decide on a strategy; otherwise, talks can end in stalemate, bad feelings, and loss of business. Being able to negotiate is vital to building strong working relationships; delivering sustainable, well-considered solutions (rather than a short-term fix); and avoiding future conflicts.

Reaching agreement

Any strategy, from a wage negotiation between a trade union and employer to a sales negotiation between a customer and supplier, depends on the relationship between the two parties. Good negotiation should leave each party feeling satisfied with the outcome of the discussion and ready to do business again.

Prepare and plan

- Set objectives and ideal outcome (and assess those of other party).
- Rank and value issues and think of possible concessions.
- Consider ideal agenda and meeting place. Rehearse.

Define ground rules

- Agree on logistics—location, room setup, agenda, schedule, number of negotiators.
- Define etiquette, such as no cell phones, one person speaks at a time, formal breaks.
- Agree on how information is to be presented and recorded.

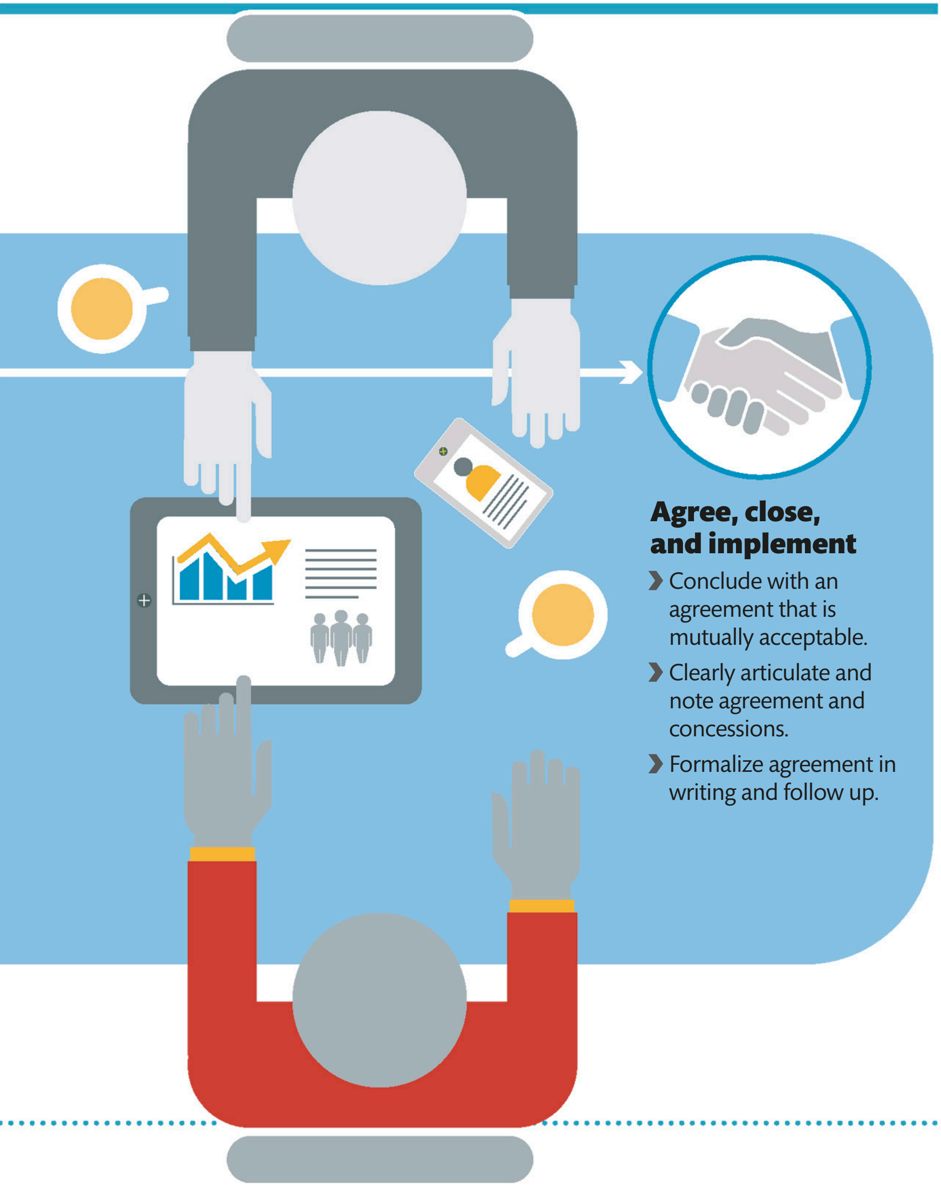
Propose, clarify, and justify

- Ensure both sides have equal opportunity to put forward their case.
- Clarify any points of disagreement.
- Focus discussion on understanding rather than resolving.

Bargain to solve problems

- Offer alternative proposals and concessions.
- Discuss what is acceptable to each side.
- Aim to find win-win solutions.

65%
of face-to-face communication is nonverbal.

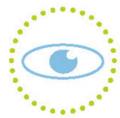


Agree, close, and implement

- Conclude with an agreement that is mutually acceptable.
- Clearly articulate and note agreement and concessions.
- Formalize agreement in writing and follow up.

BODY LANGUAGE IN DIFFERENT CULTURES

With international negotiations, it can be hard to read body-language signals, particularly as the meaning of gestures can vary.



Eye contact Chinese people avoid direct eye contact to show respect, while American people see lack of eye contact as a sign of shiftiness.

Facial expressions When emotions are high in the US, it is acceptable to frown, even to swear, but not to cry. Japanese people might smile or laugh, but never frown or cry.

Head movements In much of Europe and the US, people nod to mean yes and shake their head to mean no. But in some parts of the world, such as in Bulgaria, it is the opposite way.

Gestures Western cultures use a hand extended toward a person to indicate "Come here." Chinese people would see this gesture as offensive.

Posture In the US, being casual is valued; people might slouch when standing or sitting. In some European countries, such as Germany, a slouching posture is considered rude. Formality is also valued in Japan, particularly the ability to sit upright and still.

Flexible working

Businesses are taking a more flexible approach to how and where their staff work. Faster Internet connections, cloud computing, and better apps have made it possible for workers to collaborate effectively at a distance, and many companies are recognizing the benefits of allowing them to do so. Are shared workspaces becoming a thing of the past?

How it works

Advances in communications technology have made it easier for businesses to allow employees to work in ways that suit their particular needs. As of late 2021, 21% of workers in the US were working from home, and that number was rising steadily. The COVID-19 pandemic that began in early 2020 accelerated this process. As countries around the world put lockdowns into effect to curb the spread of the virus, businesses and employees scrambled to adapt to the new reality of doing what they used to do in person over the Internet via video call, email, instant messaging, and other means. Even as lockdowns lifted, many employees preferred to keep working from home. The result is that businesses now have a clear understanding of the benefits—and drawbacks—that flexible working can create, and most are unlikely to insist on every employee working in the same physical space all the time as they move forward.

Working remotely: pros and cons

Pros	Cons
✓ Fosters a better work/life balance, creating happier, more productive employees	✗ Not suitable for every business—many still need staff to collaborate in person
✓ Gives staff time to focus on their work, with fewer distractions	✗ More time required to ensure clear communication
✓ Frees up room in company workspaces, allowing businesses to save on rent	✗ Workers potentially feel isolated; team culture harder to foster
✓ Gives organizations access to a global talent pool	✗ Business operations completely reliant on technology functioning properly

25% of workers in **advanced economies** can **work from home** three to five days a week with **no loss of productivity.**

Going remote: what you need

Maximizing the benefits and minimizing the problems of flexible working requires the right setup. This means not only making sure that the appropriate tools and technology are in place for all staff members, but also adjusting work practices and developing skills.

Tools

Workspace

Wherever they choose to do their job, staff need a suitable space to work: somewhere with good lighting, free from excessive distractions, and furnished with a comfortable desk and chair.

Hardware

Minimum requirements are a laptop and a reliable Internet connection. An ergonomic wireless mouse, good headphones, a webcam, a microphone, a footrest, and a document holder can be handy extras.

Communication tools

Alongside email, video-call platforms, such as Zoom and Skype, are indispensable for providing face-to-face contact, while instant-messaging apps, such as Slack, help people ask questions and share documents. Other collaboration tools, including online whiteboards and project management apps, are also useful.

File-sharing services

Staff need to be able to read and edit company documents and exchange them with colleagues. This might be through remote access to the company server or via online file-sharing services, such as Microsoft 365 or Google Drive. Such services store data on remote servers in the "cloud," allowing workers to share documents, track changes, manage different versions of them, and tag other users wherever they are.

Specialty software

Workers may also require access to software specific to their roles or unique to the business. Cloud-based subscription packages can make professional software easier to deploy.

Skills

Communication skills

Working remotely prevents people from picking up on—or displaying—many of the nonverbal cues that we use when communicating, so extra effort is required to communicate clearly.

People-management skills

For the same reason, interpersonal skills are also important. Reaping the benefits of flexible working means taking time to understand people's individual circumstances: keep in regular contact, listen carefully, show empathy, and offer support if needed.

Technology skills

People must know how to use the technology that they need to work remotely to do their jobs properly. Understanding how to protect data to prevent security leaks is also key.

Time-management skills

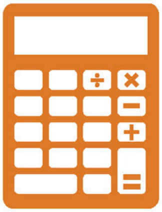
Boundaries between work and home life can blur when working from home, so maintain a structured schedule. Start and finish on time, take regular breaks, and organize work hours carefully, keeping meetings to a minimum and blocking off enough time to get work done.

Flexibility

By its nature, flexible working means adapting to constant change. The key is to stay receptive; take the time to understand new problems, requirements, and technologies; and adopt fresh approaches.

HOW **FINANCE** WORKS

Financial reporting ❯ Financial accounting
Management accounting ❯ Measuring performance ❯ Raising financing



Financial reporting

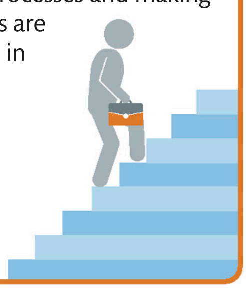
Financial reports are everywhere: a bill at a restaurant is a financial report, as are sales receipts and bank statements. In business, however, financial reporting refers to the financial statements that make up a company's annual report and accounts. Compiled by accountants, they provide investors and lenders with information to assess a company's profitability and enable company managers, the government, tax authorities, and other stakeholders to evaluate the business.

Types of financial reports

Financial reports take many forms and can contain a vast amount of information about a company's finances, work, core business values, performance, employees, and compliance with local, logistical, domestic, and international laws. The most important financial report, or statement, is usually the annual report—essentially a collection of many other, smaller reports—which sums up how the business has performed in the last year. There is a multitude of laws, regulations, and guidelines governing what should be put into this report.

THE ACCOUNTING CYCLE

The eight steps of the accounting cycle are used by nearly all accountants. The cycle helps by standardizing processes and making sure that accounting jobs are performed correctly and in the same way and order for every activity.
See pp.102–103.



The annual report

Financial statements usually appear in a company's annual report and sum up its financial activities in a standardized way for different audiences to interpret quickly and clearly. These statements take diverse forms, and being able to deconstruct them is a vital skill for accountants and businesspeople, making it simple to see how well a business is performing and why.

50%
of accounting students worldwide are women.

TYPES OF ACCOUNTING

There are seven widely recognized types of accounting:

- **Financial** Drawn up by accountants; used by investors, creditors, and management. *See pp.110–129.*
- **Management** Used by managers to control cash flow and budgets to forecast sales. *See pp.130–143.*
- **Governmental** Also called public finance accounting; used by the public sector for noncommercial accounting.
- **Tax** Dictates exact rules that companies and individuals must follow when preparing and submitting tax returns.
- **Forensic** Engages in disputes and litigation and in criminal investigations of fraud. *See pp.152–153.*
- **Project** Deals with a particular project; a useful aid for project management.
- **Social and environmental** Shows how a company makes a positive difference to the community and environment.

Financial statements

- **What's in an annual report?** A full record of company performance according to various criteria, plus accounts. *See pp.104–105.*
- **What are the statements?** The main one is financial; others include sustainability, directors' pay, and charitable donations. *See pp.106–107.*
- **Who reads which statements?** Sections are relevant to banks, shareholders, government, auditors, staff, and media. *See pp.108–109.*
- **What do the notes mean?** Main statements are annotated in detail. *See pp.104–109.*
- **What are the rules?** Accounting principles regulate financial reports. *See pp.112–113.*
- **Which are the most important financial statements?** Profit-and-loss statements, balance sheets, and cash-flow statements contain key facts. *See pp.114–121.*

The accounting cycle

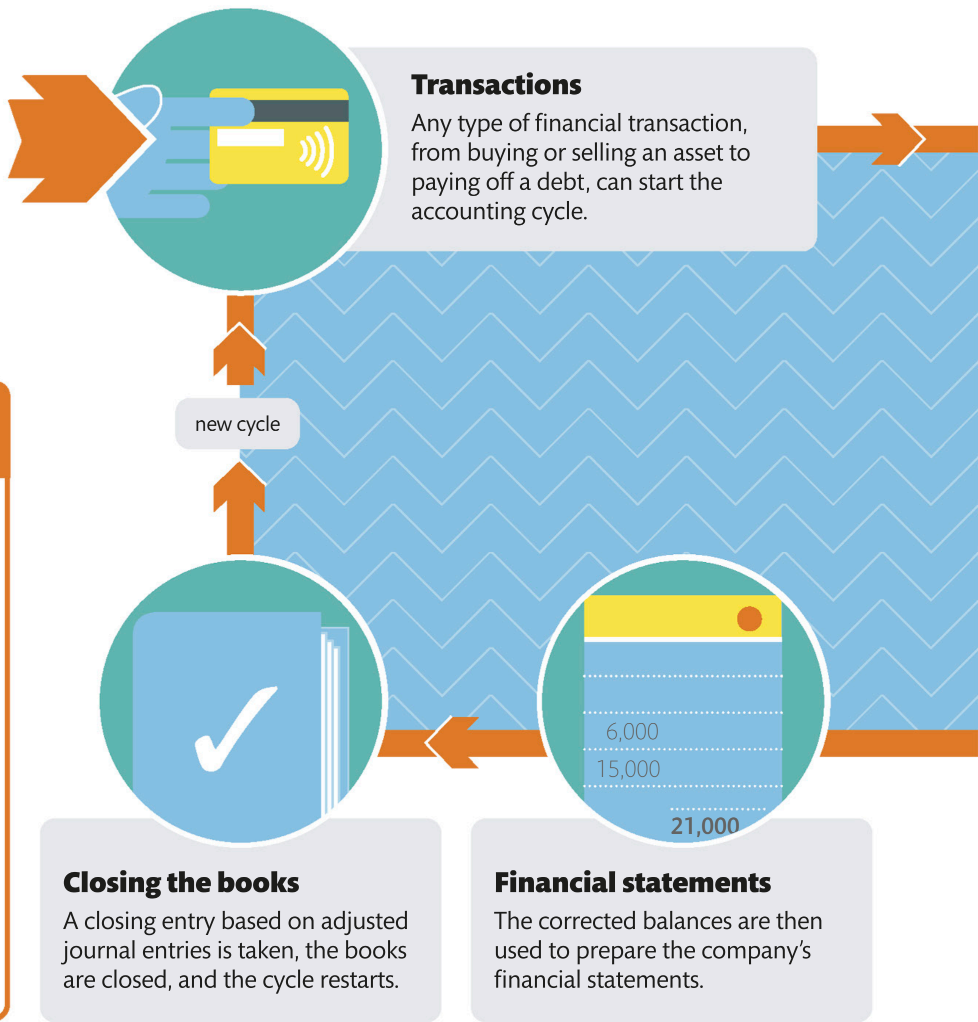
The accounting cycle is a step-by-step process bookkeepers use to record, organize, and classify a company's financial transactions. It helps keep all accounting uniform and eliminate mistakes.

How it works

The cycle works as a method of organizing workflow into a cyclical chain of steps that are designed to reflect the way assets, money, and debts have moved in and out of a business. It progresses through eight different steps, in the same order each time, and restarts as soon as it has finished. The cycle can be based on any length of time—this is known as an accounting period—and usually lasts a month, a quarter, or a year. Accounts that deal with revenues and expenses return to zero at the end of each financial year, while accounts showing assets, liabilities, and capital carry over from year to year.

The eight-step cycle

The processes shown here are repeated in the same way for every accounting period. All businesses go through different phases, and the accounting cycle works by reflecting that. The financial statement, which is prepared toward the end of each cycle, is helpful in showing how strongly the business has performed during each period of time.



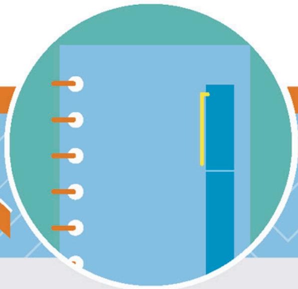
Transactions
Any type of financial transaction, from buying or selling an asset to paying off a debt, can start the accounting cycle.

Financial statements
The corrected balances are then used to prepare the company's financial statements.

Closing the books
A closing entry based on adjusted journal entries is taken, the books are closed, and the cycle restarts.

BOOKKEEPING AND ACCOUNTING

- **Internal controls** A method of deploying, measuring, and monitoring a business's resources. This helps prevent fraud and keep track of the value of assets.
- **Double-entry bookkeeping** The process of recording all transactions twice—as a debit and as a credit. If a company buys a chair for $100, its debit account increases by $100 and its credit account decreases by $100.
- **Bad debts** Debts that cannot be or are unlikely to be recovered and so are useless to the creditor (lender), who writes them off as an expense.



Journal entries

Accountants then analyze the transaction and create a record of it—a journal entry—in the company's accounting system.

Posting

Journal entries are then transferred to the general ledger—a digital record logging all the company's accounts.

NEED TO KNOW

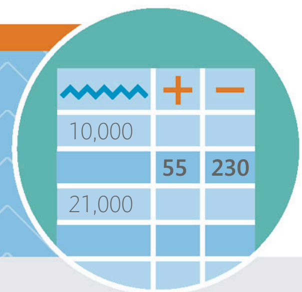
- **Debits** An entry where assets and expenses increase. In double-entry accounting, debits appear on the left-hand side of the account.
- **Credits** An entry where revenue, owners' equity, and liabilities increase. In double-entry accounting, credits appear on the right-hand side.
- **Chart of accounts** List giving the names of all of a company's accounts, used to organize records
- **Audit trail** Full history of a transaction, allowing auditors to trace it from its source, through the general ledger, and note any adjustments made

Trial balance

A list of all the company's accounts is prepared at the end of the accounting period, usually a year, quarter, or month.

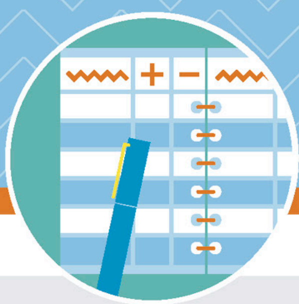
72%

of UK independent contractors **do their** own accounts.



Worksheet

Often, trial balance calculations don't accurately balance the books (*see pp.116–117*). In such cases, changes are made on a worksheet.



Adjusting journal entries

Once the accounts are balanced, any adjustments are noted in journals at the end of the accounting period.

Financial statements

The formal records of a business's financial activities are presented as financial statements. Most jurisdictions require accurate information by law, and financial directors and auditors are liable for its contents.

How it works

Financial statements summarize a company's commercial activities clearly and succinctly, with details of the business's performance and changes to its financial position. They are aimed at several parties, so they need to be detailed but also comprehensible to the general public. The statements are usually presented together in the form of an annual report, with in-depth accounts and footnotes to give detail. Legal requirements vary, but accounts must be exact.

What's in an annual report

The contents page shows where to find the big three statements—the balance sheet, cash-flow statement, and profit-and-loss statement—and softer information, such as stories about staff and opinions of other stakeholders. The annual report provides an opportunity to impress shareholders and lenders as well as fulfill legal reporting obligations. It will contain all, or most, of the following.

It is common for the chair to write an introduction focusing on the positives and explaining any negative parts of an annual report for the benefit of shareholders.

These pages contain much of the company's information on its environmental protocols, most of which are industry-specific. (*See also pp.122–123.*)

This section underlines a company's social ethos, in particular its community involvement. Different types of companies may focus on different values.

A section on employees discusses such areas as staff development and training, health and safety, and key statistics on staff satisfaction.

A brief overview summarizes the key areas of finance for the company, including overall performance, turnover, operating costs, capital investment, depreciation, interest charges, taxation, and dividends. (*See also pp.114–121.*)

The infrastructure pages of an annual report are a good place to supply more detail about the company's fixed assets and explain why the company is an attractive investment for investors.

CONSOLIDATED FINANCIAL STATEMENTS

In an era of globalization, large corporations are now commonly made up of multiple companies. Companies owned by a parent company are known as subsidiaries and continue to maintain their own accounting records, but the parent company produces a consolidated financial statement that shows the financial operations of both companies. Depending on the jurisdiction's reporting requirements, however, if a company owns a minority stake in a second company, then the latter will *not* be included in the former's consolidated financial statement.

NEED TO KNOW

- **Subsidiary** One company that is controlled by another, usually a holding company
- **Holding company** A company set up to buy shares of other companies and then control them
- **Globalization** The process of businesses developing such large multinational presences that they transcend international borders

Performance indicators are common across all industries. They measure such areas as customer satisfaction and the quality of goods or services provided by the company.

In the directors' report, members of the board of directors give their professional opinions on how the business has performed over the last year.

The environmental accounting section contains figures that pertain to the environment, often those stipulated by law—for example, greenhouse gas emissions.

Auditors are independent and check the accuracy of companies' accounts. This helps eliminate mistakes and track fraud.

The board of directors, governance report, and statement of directors' responsibilities sections indicate who is leading the company, showcases their credentials and roles, and reveals their pay.

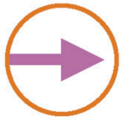
Notes to the accounts are a key part of financial statements. They provide extra detail, insight, and explanation of the bare-bones figures supplied in earlier pages of the report.

Deconstructing a financial statement

The profit and loss account shows revenues, costs, and expenses—how much money the business makes—over an accounting period. The balance sheet shows what a business is worth at the time it is published and is relevant to investors, as it reveals assets, liabilities, and shareholders' equity—all useful for gauging business health. The cash-flow statement shows the movement of cash within a business—its liquidity. However, along with the big three financial statements, an annual review contains a wealth of information about a company's performance, of interest to its stakeholder groups. It is often the notes that bring statements to life.

TAXES

The percentage of business taxes taken by governments varies from country to country, but the generic types remain similar:



- **Direct taxes** are levied directly on profits or income and include income taxes and taxes relating to sales or purchases of property and other capital assets.

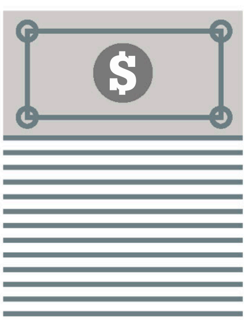
- **Indirect taxes** are paid on goods or services, such as sales taxes. Indirect taxes are often targeted to reduce consumption of harmful goods, a factor relevant to companies working in the alcohol and tobacco industries.

- **Green taxes** are increasingly common and are often indirect. They are generally used as a way of prohibitively increasing the price of goods or services harmful to the environment, such as air travel, landfill sites, or fuel, to diminish their use.

- **Corporation tax** is only paid by companies, not by sole proprietors or partnerships. It is levied as a percentage of the company's total profit.

Case study: the details

Financial statements are presented as part of the annual report, which also publishes case studies, quotations, statistics, and profiles of customers, suppliers, employees, and directors. The notes, often running to 20 pages or so, contain tables and text that flesh out the financial information. This example shows the sustainable investment figures in the annual report of a fictional utility company.



Our finance

This section contains the headline financial figures of the business, such as profits, taxes paid, assets owned, liabilities, and dividends paid out, as well as some more detailed explanation of the figures.

Sustainable investment

The utility company's investment in sustainability includes mandatory expenditure and extra discretionary expenditure.

		2013 $m	2012 $m
	CUSTOMERS AND COMMUNITIES	130	110
	ENVIRONMENT	115	102
	EMPLOYEES	91	88
	TOTAL	**336**	**300**

NEED TO KNOW

- **Monopoly** Situation in which there is just one supplier of a particular product or service; without government control, a company with a monopoly could make prices high and quality low, as consumers would have no alternative.
- **Oligopoly** Industries that have a small number of suppliers. The competition is not as intense as in the free market, so governments often impose regulations on companies to ensure quality and fair prices.
- **Remuneration** Money paid for work or a service provided—the financial term for pay; may include bonuses or share options.

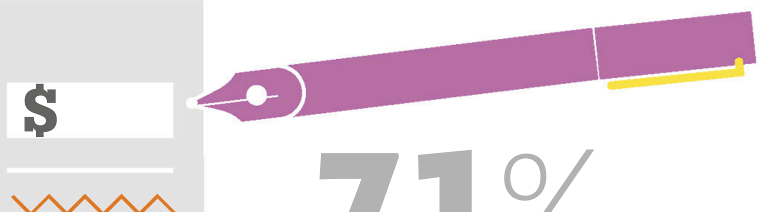
BOARD OF DIRECTORS

Much of what might be considered personal information about directors of public companies is in the public domain. It is usually a legal obligation to disclose:

- Names of executive directors
- Names of non-executive directors and whether they are independent or shareholders
- Shareholding
- Board attendance record
- Dates of directors' terms of office
- Remuneration, including bonus, share options, pension plans, and benefits
- Notice period
- Termination payment
- Potential conflicts of interest

Charitable donations

Companies boast of their philanthropy in the annual report, detailing how much they have given away and how it has helped. They may support charities relevant to the nature of their business or let employees vote on recipients.



71% **of CEOs feel personally responsible for ensuring that their organization's sustainability policies reflect their customers' values.**

Customer satisfaction

Overall, this section shows how the company works with customers to improve service and support. In monopoly and oligopoly industries, customer satisfaction is particularly important, as governments often set high targets.

Financial statements for users

The many financial statements included in the annual report are a gold mine of information for those who know how to read them. They provide headline profit figures, explanations of issues from directors, detailed financial data, and information about companies' operations and policies. For this reason, financial statements are useful to a wide range of stakeholders, from the company's employees, customers, and shareholders to potential investors, governments, tax authorities, journalists, credit-rating agencies, banks, and the general public.

Who reads what

Different stakeholders are interested in different parts of the annual review. Customers of a service provider, for instance, may look at the section on customers and community, while potential lenders go to the financial statements.

Stakeholder	Important parts	Why?
SHAREHOLDERS	❯ Profit-and-loss account ❯ Balance sheet ❯ Dividends	❯ To see how much money the company is making ❯ To assess the long-term strength of the company ❯ To see how much will be paid out to them
EMPLOYEES	❯ Our employees ❯ Governance report ❯ Performance indicators	❯ To check the health of the company in order to assess their job security ❯ To see how much executive and non-executive directors are paid ❯ To see how well the company is performing and if it can improve
AUDITORS	❯ The whole statement ❯ Independent auditor's report (written by the auditor)	❯ To assess whether the accounts are error-free ❯ To ensure that the company has complied with Generally Accepted Accounting Principles (GAAP) (*See pp.112–113.*)

UNDERSTANDING REVIEW JARGON

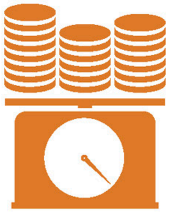
An annual review includes essential information about the financial health of the business, such as:

Post-tax return on capital
- A percentage figure estimated by dividing income after tax by the amount of investment. It is useful for showing shareholders the kind of returns they can expect on their investments.

Gearing
- Gearing is a company's debt compared to its equity and is expressed as a percentage. The higher the gearing, the more risk a company is taking. *See pp.174–175.*

Credit rating
- Credit ratings assess the likelihood that loans will be repaid. Credit rating agencies often give ratings in the form of letter grades, with AAA being the highest, indicating that a company has a strong capacity to meet financial commitments. C and D grades are the lowest.

Stakeholder	Important parts	Why important?
GOVERNMENT/TAX AUTHORITIES	Taxation; Independent auditor's report; Environment section and environment-related notes	To check that the figures are correct and the correct amount of tax has been paid; To check the audit and that they are satisfied with the accounts; To check that environmental laws have been adhered to
FINANCIAL INSTITUTIONS/BANKS	Balance sheet	To see the company's assets and liabilities and assess its strength; To decide whether it is wise to lend to the company
JOURNALISTS	Chair's introduction; Accounts and notes	To find elements to quote; To see how strongly the company has performed; To analyze why a company has been performing well or poorly and see whether there is a story to write



Financial accounting

A company's financial accounts classify, quantify, and record its transactions. They are extremely useful for people outside the business, such as creditors and potential investors, as well as those currently involved with making investment decisions. For this reason, the accounts should be concise and clearly present the timing and certainty of future cash flows, so that people looking at the company can decide whether or not to invest in, lend money to, or do business with it.

Key elements

The profit-and-loss account, balance sheet, and cash-flow statements are the most important financial statements in an annual review, supplemented by the report's notes. To understand these statements, a knowledge of accounting principles, depreciation, amortization, and depletion is vital. Accountants also need to understand the legal requirements that the statements must satisfy and how environmental laws can affect a business and its accounts.

Accounting standards

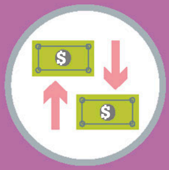
Generally accepted principles standardize practice worldwide to ensure accuracy and prevent fraud. *See pp.112–113.*

- International standards simplify account reporting.
- Companies must meet environmental accounting rules and regulations. *See pp.122–123.*

Profit-and-loss statement

Shows how much money a company is making and is especially useful for potential investors and stakeholders. *See pp.114–115.*

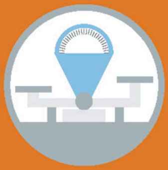
- Outlines revenues and gains minus expenses and losses or operating costs.
- Informs a company whether a profit warning is needed.



Balance sheet

Gives a snapshot of how much a business is worth at a certain time and is a good indication of its long-term health. *See pp.116–119.*

- Balances company's assets against its equity and liabilities.
- Lists different types of assets, including tangible fixed assets and current assets.

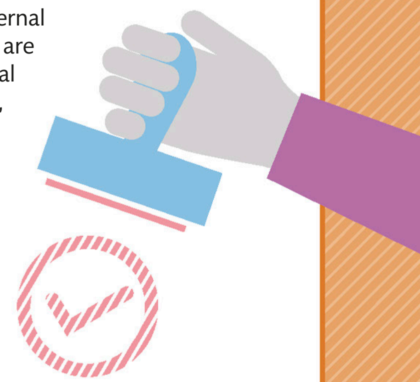


$74 billion

the total value lost by shareholders in the 2001 Enron accounting scandal

AUDITING

The accounts of public companies are given unbiased scrutiny by external accountants to verify that they are accurate and clear. This is a legal requirement in most countries, designed to ensure market confidence in the business world and transparency in corporate finance. A company may also have an internal audit process, which means that its accounts are checked before being submitted to an external auditor.



Cash-flow statement

Reveals a company's liquidity by tracking the flow of cash—money or short-term investments—in and out of the company.
See pp.120–121.

- Shows whether a company can sustain itself, grow, and pay debts.
- Details cash flow from operating, investing, and financing activities.

Environmental accounting

Accounts for myriad environmental rules and regulations that oblige companies to mitigate the impact of business activities.
See pp.122–123.

- Showcases green credentials in financial statements.
- Reveals compliance with environmental, social, and governance criteria.

Depreciation

Accounts for the decrease in value over time of tangible fixed assets in order to spread the cost of assets over their economic life.
See pp.124–127.

- Can be calculated with a number of different methods.
- Tangible fixed assets include buildings, plants, and machinery.

Amortization and depletion

Account for the decrease in value over time of a range of intangible assets, loans, and natural resources.
See pp.128–129.

- Intangible assets include patents, trademarks, logos, and copyrights.
- Natural resources include minerals and forests.

Profit-and-loss statement

A profit-and-loss statement is a financial statement that shows all revenues, costs, and expenses during an accounting period. It is also known as an income statement or an income and expense statement.

How it works

The purpose of the profit-and-loss statement is to show the profitability of a business during a given period. Along with the cash-flow statement and the balance sheet, it is the most important financial statement that a business produces, as it shows investors how profitable the company is. The statement usually works by showing revenues and gains, minus expenses and losses from business activities, as well as the sale and purchase of assets. Businesses that are sole proprietorships or partnerships are generally not required to submit profit-and-loss statements.

How to read a profit-and-loss statement

Profit-and-loss statements commonly illustrate the financial performance of a business over a particular month, quarter, or year. The key pieces of information are the figures for turnover (or revenue) and operating profit. If profits are going to be lower than expected, the company may put out a profit warning ahead of releasing the statement.

Case study: profit-and-loss statement

This example of a profit-and-loss statement for a fictional utility company shows that it is making a profit.

	Year 2021 $m	Year 2020 $m
Turnover	**607.5**	**575.9**
Operating costs	–372.7	–354.2
Operating profit	**234.8**	**221.7**
Financial income	0.6	0.2
Financial expenses	–98.1	–100.3
Net financing expense	**-97.5**	**-100.1**
Profit before tax	**137.3**	**121.6**
Taxation	61.2	20.8
Profit after tax	**76.1**	**100.8**

Amount of money taken by the business over a certain time; in this case, there was a 5.5 percent increase in turnover from the previous year.

Profit earned from the business's core operations after expenses have been taken off, but before taxes have been deducted; it does not include money made on investments.

Profit before tax after all income and expenses have been taken into account, excluding extraordinary payments.

Level of profit that can be paid out in dividends to the company's shareholders.

TYPICAL EXPENSES

Payroll
Salaries and wages paid to staff, temporary contractors, and indirect labor

Utilities
Water, electricity, and gas; postage and shipping; transportation

Insurance
Insurance on fixed assets and personal liability insurance for employees

Phone/internet bills
Cost of telephone, broadband Internet, and mobile devices used by employees

Advertising
Sales and marketing of the company and its products

IT and office supplies
IT equipment and software used by employees; stationery, printer supplies, furniture, lighting

Legal fees and professional services
Accounting and legal fees, payable to accountants, auditors, and legal advisers

Interest on loans
Interest paid on money borrowed, which counts as a business expense

Tax
Varying among jurisdictions, this may include payroll tax and corporation tax

Entertainment
Legitimate costs of business entertaining

Case study: operating costs

This table shows the utility company's operating costs in more detail. It is important to read any notes about depreciation and ordinary and extraordinary costs and gains.

Employee costs, including basic pay, pensions, Social Security contributions, and directors' remuneration

Term given to the gradual decline in an asset's value, caused by such factors as wear and tear and market conditions

Decrease in value over time of intangible assets or loans

Profit or loss on the sale of fixed assets

Leasing costs for buildings and equipment

Research and development carried out to improve the reliability and effectiveness of services

Funds spent by the company to create capital assets that have a life greater than one year

	Year 2021 $m	Year 2020 $m
Employee costs	**133.3**	**125.5**
Utility costs	36.3	35.1
Raw materials and consumables	17.1	16.1
Insurance	25.5	26.1
Depreciation	**117.9**	**116.9**
Amortization of intangible assets	8.1	5.1
Loss/[gain] on disposals of fixed assets	**[0.3]**	**[4.9]**
Operating leases for plant and machinery	**5.3**	**4.8**
Research and development	**1.9**	**0.3**
Other operating costs	142.0	132.0
Own work capitalized	[111.2]	[100.1]
	375.9	**356.9**
Fees paid to the auditor	0.3	0.3

Figures in brackets represent negative numbers.

Balance sheet

A balance sheet is a financial statement that shows what a business is worth at a specific point in time. Its primary purpose is to show assets, liabilities, and equity (capital) rather than financial results.

How it works

The balance sheet essentially shows what the company owns, what it owes, and how much is invested in it. It is based on the accounting formula, sometimes called the balance-sheet equation, which is the basis of double-entry bookkeeping. This shows the relationship between assets, liabilities, and the business's capital—what the company owns (assets) is purchased either through debt (liability) or investment (capital). The equation always balances, as everything a company owns has to have been bought with the business's funds or through borrowing.

NEED TO KNOW

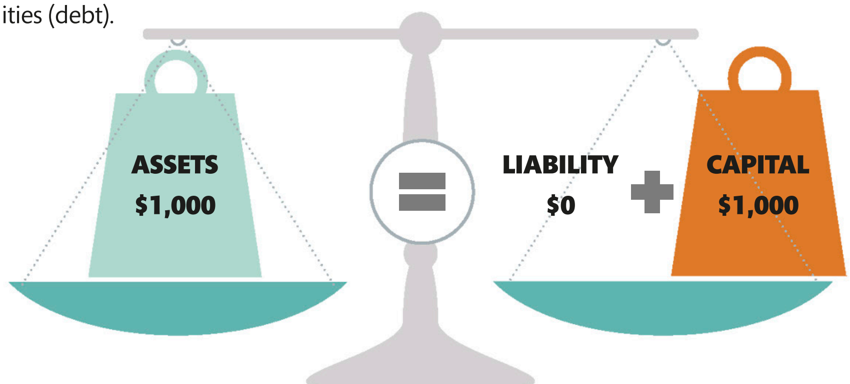
- **Deferred income** Income a company receives for goods or services that have not yet been delivered or provided. Until income is received, it is recorded on a balance sheet as a liability.

The balance-sheet equation

As the name suggests, the balance sheet must always balance. This is because everything the business owns (its assets) must be offset against the equivalent capital (or equity) and liabilities (debt).

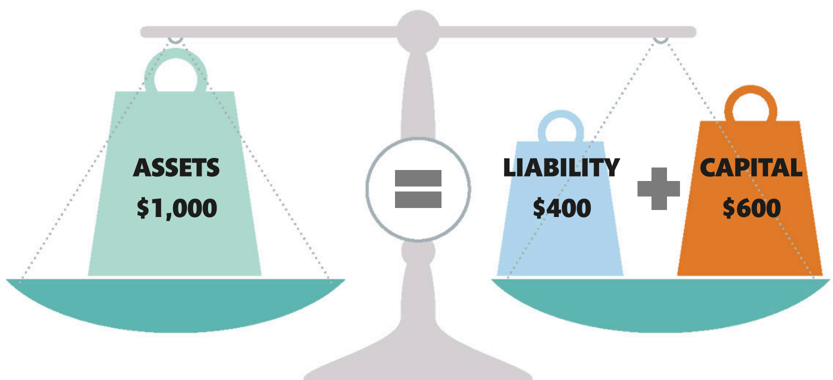
Company has no liabilities

For example, a young business may have assets of **$1,000**. It currently has no liabilities, so its capital is equal to its assets—that is, it is the amount of equity the owners or shareholders have invested in the business. Using the accounting formula, the equation would look like this:



Company incurs $400 in liabilities

After spending **$400** on, for example, an illuminated sign for the storefront, the owner incurs **$400** in liabilities, and so the formula changes. However, because the sign is worth **$400**, and the owner has **$600** remaining, the equation remains balanced—as it always does.



Case study: balance sheet

This example from a fictional transportation infrastructure company shows how a balance sheet works in practice.

Fixed assets (or noncurrent assets) are not easily converted into cash and usually last longer than one year. They are either tangible, such as land, or intangible, such as a logo.

Current assets are assets that last one year or less and can be easily converted into cash. Cash, cash equivalents, and inventory are the most common current assets.

Current liabilities are the amounts that the company owes to individuals or organizations. Here, the money must be repaid in the current financial year.

Net current assets equal current assets after current liabilities have been deducted.

Total assets less current liabilities is the sum of fixed and net current assets minus liabilities due within the current financial year.

Liabilities due in more than one year are amounts due to creditors, which are deducted from total fixed and net current assets.

Net assets are what is left once liabilities have been deducted from the company's fixed and net current assets to give the overall net assets.

Shareholders' funds, or owner's equity, is the remaining capital; this money can be reinvested into the business or paid out as an annual dividend.

ASSETS, LIABILITIES, AND CAPITAL	Year 2021 $m	Year 2020 $m
Fixed assets		
Tangible assets	**3,872.4**	**3,699.5**
Intangible assets	**60.1**	**44.6**
Investments	–	–
	3,932.5	3,744.1
Current assets		
Inventories	4.2	6.1
Trade and other receivables	185.1	189.6
Cash and cash equivalents	46.5	-22.4
	235.8	173.3
Current liabilities—amounts falling due within one year	–182.2	–274.4
Net current assets	**53.6**	**-101.1**
Total assets less current liabilities	**3,986.1**	**3,643**
Noncurrent liabilities—amounts falling due after more than one year		
Other interest-bearing loans and borrowings	–2,226.6	–2000.4
Contract liabilities	–6.9	–6.9
Employee benefits	–89.9	–121.1
Deferred grants and contributions	–299.2	–265.6
Provisions	–0.5	–0.9
Deferred tax liabilities	–444.3	–355.5
	–3,067.4	–2,750.4
Net assets	**918.7**	**892.6**
Equity		
Share capital	10	10
Retained earnings	908.7	882.6
Shareholders' funds	**918.7**	**892.6**

SYMBOLS FOR DEBITS AND CREDITS

Accountants use a number of different terms and symbols to indicate debits and credits. Some use "Dr" for debits and "Cr" for credits; others use brackets to show negative numbers.

Understanding the notes

The balance sheet is a useful indication of the health of a business, and it is important that investors know how to analyze it. It can be read in two ways—"at a glance," as on the previous page, where general information is summarized, or in depth, with more detailed information about each element. Provided after the summary, the detailed section of the balance sheet explains the specific financial workings of the business in a number of notes. It shows exactly where money has been gained or lost, in numbers, and it often includes a written commentary about potential developments that may affect the company, such as court cases, staffing, or availability of resources.

Balance-sheet notes

Investors may want to know more about the figures in the summary section, so additional notes and tables give detailed breakdowns of the numbers.

Case study: tangible fixed assets

This table presents details of the transportation company's tangible fixed assets (long-term assets that cannot easily be converted into cash).

Tangible fixed assets include land and machinery.

Additions are new tangible fixed assets the business has acquired this year.

Disposals are any tangible fixed assets the business has disposed of or sold this year.

Total value of the company's fixed assets is listed by category and in total.

Depreciation is the decrease in value of assets over time.

Value of depreciation of assets is listed by category and in total.

Net book value of an asset is its initial cost minus all its depreciation to date.

Combined value of the company's tangible fixed assets in each category, and also in total, is listed.

	LAND AND BUILDINGS	INFRASTRUCTURE ASSETS	PLANT, MACHINERY, AND VEHICLES	OFFICE AND IT EQUIPMENT
	$m	$m	$m	$m
Cost				
At April 1, 2020	901.1	2,300.7	1,908.2	44.1
Additions	57.1	110.6	71.5	4.1
Disposals	-1.5	-0.1	-32.2	-5.3
At March 31, 2021	**956.7**	**2,411.2**	**1,947.5**	**42.9**
Depreciation				
At April 1, 2020	-322.6	-107.8	-999.2	-25
Charge for the period	-15.1	-20.4	-22.3	-3.7
Disposals	0.9	-	24.5	4.8
At March 31, 2021	**-336.8**	**-128.2**	**-997.0**	**-23.9**
Net book value				
At March 31, 2021	**619.9**	**2,283.0**	**950.5**	**19**
At April 1, 2020	578.5	2,192.9	909.0	19.1

TOTAL
$m
5,154.1
243.3
-39.1
5,358.3
-1,454.6
-61.5
30.2
-1,485.9
3,872.4
3,699.5

Case study: debtors

Debtors are individuals or entities that owe the business money. The transportation company has various categories of debtor.

	2021 $m	2020 $m
Amounts receivable from customers	123.0	134.2
Owed by immediate holding company	22.1	23.2
Owed by fellow subsidiary companies	20.1	20.6
Owed by other group companies	0.2	–
Owed by associate companies	1.8	1.6
Prepayments	6.1	3.9
Contract assets	2.1	–
Other debtors	9.7	6.1
	185.1	**189.6**

Prepayments for services that will be received in the future that the business has already been paid for

Case study: creditors

Creditors are individuals or entities that the business owes money to. They are in credit to the transportation company.

	2021 $m	2020 $m
Trade creditors	12.0	19.1
Amounts owed to subsidiary company	20.4	18.3
Amounts owed to other group companies	0.5	0.5
Dividends	24.0	24.0
Other creditors	4.2	3.2
Corporation tax	2.6	99
Tax and Social Security	2.9	2.7
Accrued expenses	55.1	49.1
Contract liabilities	60.5	58.5
	182.2	**274.4**

Individuals or entities that are owed money for supplying raw materials or components

Money owed to related companies that are owned by the same group

Payment to shareholders

Tax and employee benefit payments

Cash-flow statement

The cash-flow statement shows the movement of cash during the last accounting period. It is important because it reveals a company's liquidity—whether it has more money coming in than going out.

How to read a cash-flow statement

The statement of cash flows, to state its official title, answers the key question of whether a business is making enough money to sustain itself and provide surplus capital to grow in the future, pay any debts, and give out dividends.

Case study: cash-flow statement

By analyzing this fictional manufacturing company's statement, which includes a comparison to the previous year, decision makers can base future plans on past cash flows.

Using profit before tax as a starting point, noncash income and expenses are deducted to reach net cash inflow from operating activities.

Returns on investment in this case are total interest received minus total interest paid, as well as interest paid on finance lease rentals.

Taxation is the sum of all taxes paid and tax credits received.

This is the sum of the figures above.

Includes changes in borrowings, loans, and dividends paid.

This is the change in cash flow, calculated by adding the two figures above—net cash flow before financing activities and net cash flow from financing activities—and must equal the difference between opening and closing cash flow for the year.

This is the change in cash flow over the year, calculated from the closing cash position minus the opening cash position.

	Year to March 31, 2021 $m	Year to March 31, 2020 $m
Net cash inflow from operating activities	340.7	349.4
Net cash from investing activities	–255.3	–245.6
Taxation paid	–28.4	–23.7
Net cash flow before financing activities	57	80.1
Net cash flow from financing activities	12	–141.8
Increase/decrease in cash and cash equivalents	69	–61.7
Opening cash and cash equivalents	–22.4	39.3
Closing cash and cash equivalents	46.6	–22.4
Increase/decrease in cash and cash equivalents	**69**	**–61.7**

How it works

The cash-flow statement is often more useful for investors assessing a business's health than other key statements because it shows how the core activities are performing. The profit-and-loss statement, for example, obscures this by adding in noncash factors, such as depreciation. Similarly, the balance sheet is more concerned with assets than liquidity.

Three types of cash flow

Cash refers to actual money as well as cash equivalents, including cash in the bank; bank lines of credit; and short-term, highly liquid investments for which there is little risk of a change in value. Cash does not include interest, depreciation, or bad debts (debts written off).

Cash flow from operating activities

The bulk of cash flow usually comes from operations and is worked out with a formula. The change in working capital (current assets minus current liabilities) can be a negative figure.

(REVENUE – COST OF SALES) - (TAXES + REPAIR COSTS + ANY CHANGE IN WORKING CAPITAL) = CASH FLOW FROM OPERATING ACTIVITIES

Cash flow from operating activities in practice

In this example, a juice company sells $100 worth of orange juice after spending $20 on oranges. It pays 25 percent of its $80 earnings in tax. Its juicing machine incurs a repair expense of $20 over the period which is another cash outlay. There is no change in working capital (short-term assets to cover short-term debt).

Cash flow from investing activities

Buying or selling assets or investments is in this category. This figure is usually a cash outflow (negative figure) due to buying more than selling, but it can be positive if there are significant sales.

Cash flow from financing activities

This includes buying or selling stock and paying out debt or dividends. Money made from selling something is called cash inflow; money lost through paying out is cash outflow.

Total cash flow

Adding all three cash flows gives the total. Separating out the three types shows decision makers the health of core activities as opposed to financing and investing, which bear little relation to day-to-day operations.

Environmental accounting

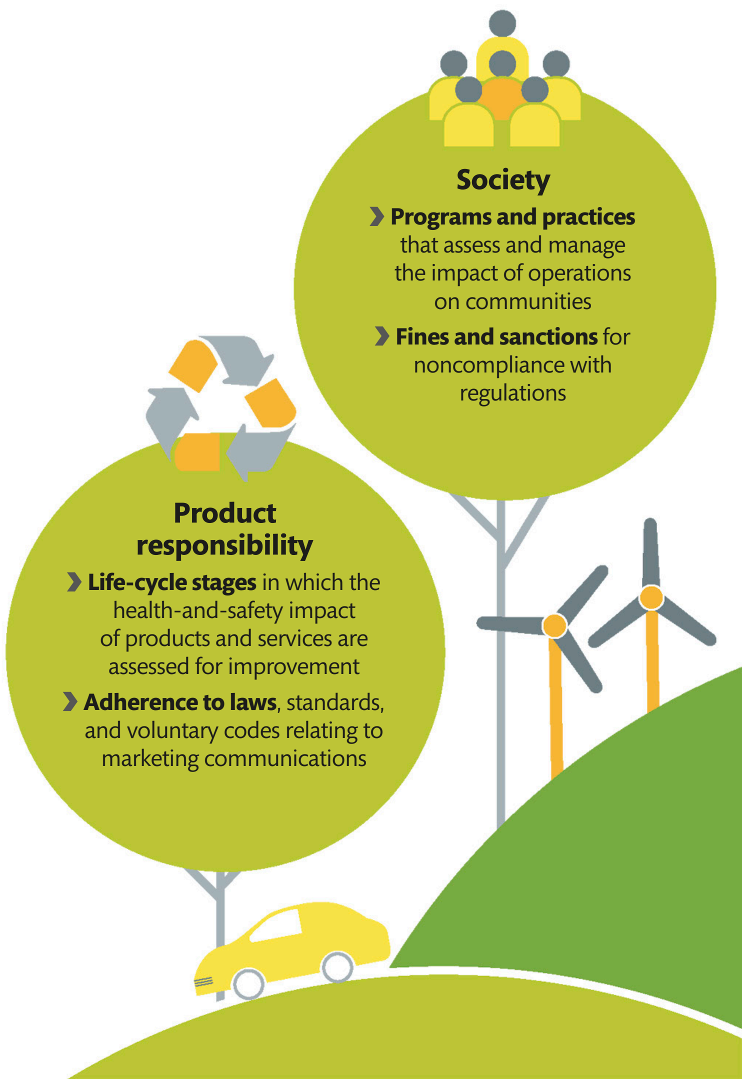
Environmental regulations force companies to consider the impact of their activities and to adopt corporate social responsibility (CSR) as they grapple with legislation, climate change, and public opinion.

How it works

Globally, there are reams of different environment acts spread across multiple jurisdictions that affect the companies operating within their borders in different ways. Areas protected by environment acts include the atmosphere, fresh water, the marine environment, nature conservation, nuclear safety, and noise pollution. International acts are usually ratified by each country individually before taking effect there. An example of a common global means of reducing greenhouse gas emissions is emissions trading ("cap and trade"), by which companies must buy a permit for each ton of CO_2 that they emit over a certain level. Those emitting under the agreed level can sell their permits to other companies.

Environmental credentials

Most companies include a section on environmental accounting in their financial statement. Some details are required by law, but the statement also gives an opportunity to showcase environmental credentials to stakeholders.



CASE STUDY

The Tata Group

The Indian multinational conglomerate prides itself on being a values-driven organization and seeks to protect the environment through its various businesses and the support of environmental NGOs via its philanthropic Tata Trusts. Projects include:

- Tata Chemicals has established a 150-acre botanical reserve on the site of a factory in Mithapur, Gujarat, protecting indigenous and other plant species.
- Tata Motors has created 245 acres of urban wetlands within its plant in Pune, western India, attracting 150 bird species and 60 types of butterfly.
- In the last 30 years, Tata Power has planted more than 18 million trees around the Walwan Dam and its hydroelectric facilities in Maharashtra state.
- Other initiatives include efforts to protect turtles and whale sharks as well as flood relief in Kerala.

GREENHOUSE GAS EMISSIONS

In some countries, companies are required by law to provide details of their greenhouse gas emissions. This is usually presented as a table in the environmental accounting section of the annual report. It includes direct and indirect emissions—by the company itself and by third parties—of gas, diesel, and other fuels; sulfur oxides and nitrous oxides; methane; and other ozone-depleting substances. In this table, from a fictional utility company, emissions are shown as $ktCO_2$ equivalents.

Appointed business	Direct fuel use	Grid electricity	Third parties	Total 2020–21	Total 2019–20
Gas, diesel, other fuels	7	0	2	9	7
Grid electricity	0	120	0	120	115
Transportation	11	0	2	13	12
Methane	20	0	3	23	23
Nitrous oxide	12	0	5	17	18
Exported renewable	0	–6	0	–6	–5
TOTAL (net emissions)	50	114	12	176	170

Depreciation

When a company buys an asset, its cost can be deducted from income for accounting and tax purposes. Depreciation allows the company to spread the cost, by calculating the asset's decline in value over time.

How it works

If a business buys a long-lived asset, such as a building, factory equipment, or computer, to help it earn income, this expenditure can be offset as a cost against income earned. However, not all this income will be generated in the year of purchase and, over time, the asset will age and become less beneficial to the business, until it becomes outdated or unusable.

Accountants do two things to turn the declining value into a tax advantage. Firstly, they work out how much the asset's value decreases over a period of time—typically a year. Secondly, they match that loss in value to the amount of income earned in that period, so depreciation becomes a deduction from taxable income.

There are several different ways to calculate depreciation. The method a company uses may depend on the kind of business, the type of asset, tax rules, or personal preference. In the United States, per IRS guidelines, companies must use MACRS (Modified Accelerated Cost Recovery System), a combination of straight-line and double declining balance methods (*see below and p.126*).

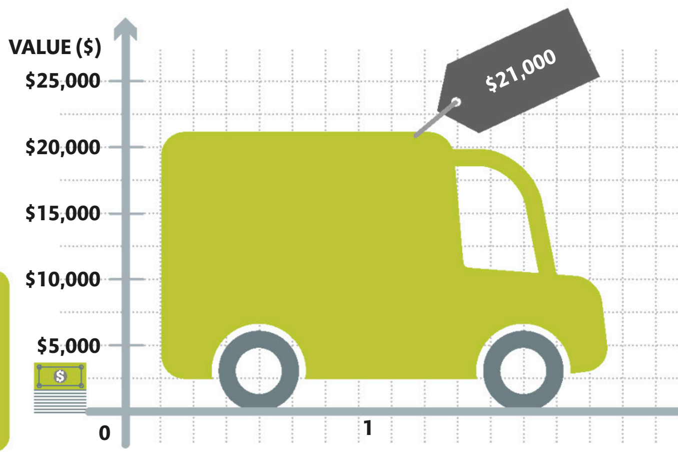
NEED TO KNOW

- **Fixed/tangible assets** Items that enable a business to operate but are not a part of trade; assets lasting a year or more qualify for depreciation.
- **Useful/economic life** Length of time an asset is fit for its purpose and has monetary value
- **Salvage/scrap/residual value** Worth of an asset once it has outlived its useful life—often set by the tax authority
- **Book value** An asset's worth on paper at any point between its initial purchase and salvage

Calculating depreciation

The straight-line method is the simplest way of working out depreciation and can be applied to most assets. Depreciation is calculated along a timeline, with value loss spread evenly over the asset's economic life. Scrap value is deducted from purchase value, and the remainder is split into equal portions over time.

$$\frac{\text{PURCHASE VALUE} - \text{SCRAP VALUE}}{\text{USEFUL ECONOMIC LIFE (YEARS)}} = \text{ANNUAL DEPRECIATION (\$)}$$



Example

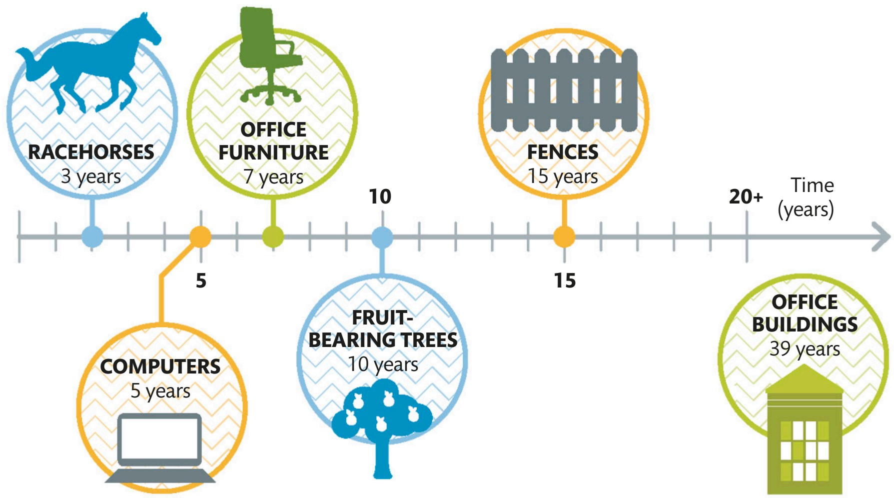
A landscaping business buys a new van for $25,000. The IRS sets its scrap value at $5,000 after five years of use.

$$\frac{\$25{,}000 - \$5{,}000}{5} = \$4{,}000$$

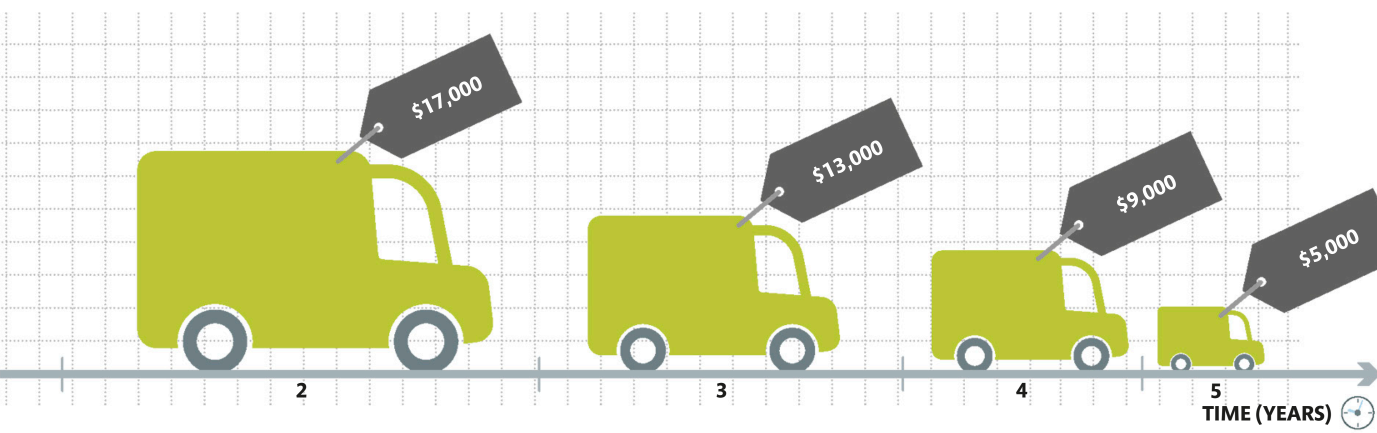
Year 1 After a year, the van's value has depreciated by $4,000 (its purchase value minus its scrap value, divided by its useful economic life). Its value is now $21,000.

TYPICAL LIFE OF FIXED ASSETS

Tax authorities often specify the typical useful (economic) life of a particular asset. This helps standardize depreciation and eliminate uncertainty about value and the number of years over which an asset can be depreciated.



60% the value the average car loses after three years



Year 2 After the second year, the value has depreciated by another $4,000. The van will lose an equal amount of value each year for the next three years of its useful economic life.

Year 3 At the end of the third year, the van has depreciated by another $4,000, and its book value is $13,000, although its actual value may be more or less.

Year 4 The van has depreciated by $4,000, to $9,000, at the end of four years of life.

Year 5 By the end of year five, the van is valued at only $5,000—its scrap value.

Applying depreciation

When calculating depreciation, there are a number of different factors to consider. For instance, a business needs to be able to predict the number of years an asset will last. Helpfully, tax authorities in most countries issue guidelines to accountants and businesses with estimates of the useful economic life of many common business assets.

Finance staff are trained to choose between the many methods of calculating depreciation to use for a given asset. Each method reflects a different pattern of depreciation, with some being more suitable for particular categories of assets. For example, the "accelerated" methods that chart rapid depreciation at the beginning of an asset's life are more suitable for technology, while the "activity" methods that link depreciation to actual hours of use or number of units produced are best suited to transportation and production lines.

Again, tax authorities in most countries offer guidelines on which method to use. Although it is technically possible for a company to use two different methods for their own accounting and for tax purposes, this is best avoided.

! WARNING

Misusing depreciation

- **The wrong method** A company must choose a method that is permissible for an asset type.
- **Frontloading** Opting for an accelerated method can result in a taxable gain if an asset is sold early, for more than its book value.
- **Claiming beyond useful life** Depreciation cannot be claimed after an asset's useful life.
- **Ignoring depreciation** If a company fails to claim depreciation, it has to report a gain from the sale, despite the loss on deduction.

Other depreciation methods

There are many different methods of calculating depreciation. Some are favored by particular tax codes, while others are specifically applicable to certain industries and types of assets, and their patterns of value loss.

Double declining balance method

A method used to claim more depreciation in the first years after purchase, which is useful for assets that lose most of their value early on. It reduces a company's net income in the early years of an asset's life, but generates initial tax savings.

$$\left(\frac{\text{PURCHASE VALUE} - \text{SCRAP VALUE}}{\text{USEFUL ECONOMIC LIFE (YEARS)}}\right) \text{X 2} = \text{ANNUAL DEPRECIATION (\%)}$$

When to use it This accelerated method can be used for assets that lose most value early, such as computers or a delivery truck.

Sum of the years' digits method (SYD)

Depreciation is calculated by dividing each year of the asset's life by the sum of the total years to give a percentage of the depreciable value. If the asset's useful life is 5 years, then the sum of the years as digits is 15 (5 + 4 + 3 + 2 + 1). In year 1, it loses 33 percent (5 ÷ 15), in year 2, 27 percent (4 ÷ 15), and so on.

$$(\text{PURCHASE VALUE} - \text{SCRAP VALUE}) \text{ X } \left(\frac{\text{REMAINING USEFUL LIFE}}{\text{SUM OF THE YEARS' DIGITS}}\right) = \text{ANNUAL DEPRECIATION (\%)}$$

When to use it This is another accelerated method that can also be used for vehicles that lose most of their value early.

DEPRECIATION ON THE BALANCE SHEET

A company's accounts have to list all assets held by the company, including all fixed assets, such as property and equipment. The accumulated depreciation of these fixed assets over the year is deducted from their value at the start of the year to give the year-end total. Without a depreciation figure, the accounts would give a false reflection of the finances of the business. The assets would appear as their original cost value, which could exceed their current value.

Fixed assets are separated from current assets.

Depreciation of fixed assets is deducted.

Total assets are calculated after depreciation has been deducted.

Previous year's total assets can be compared.

COMPANY NAME		BALANCE SHEET
Assets		
Current assets:	**2020**	**2021**
Cash	17,467.00	8,023.00
Investments	4,853.00	3,367.00
Inventories	1,056.00	2,138.00
Accounts receivable	2,165.00	3,600.00
Prepaid expenses	3,000.00	3,000.00
Other	860.00	976.00
Total current assets	**29,401.00**	**21,104.00**
Fixed assets:	**2020**	**2021**
Property and equipment	64,553.00	58,219.00
Building/site improvements	4,780.00	2,679.00
Equity and other investments	3,789.00	4,587.00
Less accumulated depreciation	5,625.00	4,171.00
Total fixed assets	**67,497.00**	**61,314.00**
Other assets:	**2020**	**2021**
Goodwill	1,577.00	1,650.00
Total other assets	**1,577.00**	**1,650.00**
Total assets	**98,475.00**	**84,068.00**

Units of production method

When a company uses an asset to produce quantifiable units, such as pages printed by a copier, it can claim depreciation with this method, which calculates depreciation according to the number of units an asset produces in a year.

$$\text{(PURCHASE VALUE – SCRAP VALUE)} \times \left(\frac{\text{UNITS PRODUCED PER YEAR}}{\text{LIFETIME PRODUCTION}}\right) = \text{DEPRECIATION (PER UNIT)}$$

When to use it This method is typically used by factories to calculate depreciation on machines that produce units of goods.

Hours of service method

The asset's decline in value is measured according to the number of actual hours it is in use. To calculate depreciation with this method, the company measures the hours of use per year as a percentage of the estimated total lifetime hours. It is particularly useful for transportation industries.

$$\text{(PURCHASE VALUE – SCRAP VALUE)} \times \left(\frac{\text{HOURS USED PER YEAR}}{\text{LIFETIME HOURS}}\right) = \text{DEPRECIATION (PER HOUR)}$$

When to use it This method may be used to match an airplane's flying hours with the revenue generated from those hours.

Amortization and depletion

Similar in concept to depreciation, amortization and depletion are used by accountants to show how intangible assets and natural resources, respectively, are used.

How it works

Amortization is how the cost of purchasing an intangible asset, such as copyright of an artwork, is spread over a period of time, usually its useful lifetime. It is shown as a reduction in the value of the intangible asset on the balance sheet and an expense on the income statement. In lending, amortization can also mean the paying off of debts over time. Depletion shows the exhaustion of natural resources, such as coal mines, forests, or natural gas.

Amortization in practice

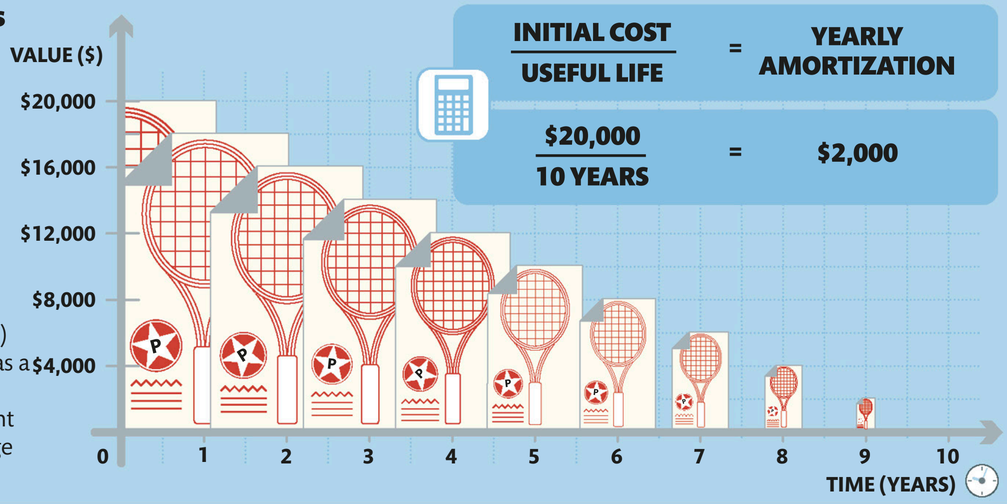
There are two types of amortization: one for spreading the cost of an intangible asset and the other for loan repayment. Both are calculated in similar ways, but loan repayments are worked out as a percentage.

Intangible assets

In this example, a company buys an intangible asset—a patent for a new, revolutionary type of tennis racket—for $20,000. The patent will be useful for 10 years, so its cost is recorded as a $2,000 amortization (expense) each year rather than as a one-time cost. Unlike tangible assets, a patent does not have a salvage value (*see p.124*).

$$\frac{\text{INITIAL COST}}{\text{USEFUL LIFE}} = \text{YEARLY AMORTIZATION}$$

$$\frac{\$20{,}000}{\text{10 YEARS}} = \$2{,}000$$



Loan percentage

If a company has an outstanding loan worth $150,000 and pays off $3,000 of this loan each year, then $3,000 of the loan has been amortized. It can also be said that 2 percent of the loan has been amortized, as it will take 50 years to repay the loan at this rate.

$$\frac{\text{COST OF LOAN}}{\text{YEARLY REPAYMENT}} = \frac{\text{YEARS TO REPAY}}{100} = \%$$

$$\frac{150{,}000}{3{,}000} = \frac{50}{100} = 2\%$$

GOODWILL

In business, goodwill describes an intangible asset based on a company's reputation, including loyal customers and suppliers, brand name, and public profile. Goodwill arises when one company buys another for more than the fair market value of its net assets (total assets minus total liabilities). For example, if Company A buys Company B for $10 million, but the total sum of its assets and liabilities is $9 million, the goodwill is worth $1 million. According to International Financial Reporting Standards since 2001, goodwill does not amortize, so it does not appear as amortization in financial statements. However, if the value of goodwill falls (through negative publicity, for example), it can be recorded as an impairment.

NEED TO KNOW

- **Intangible assets** Nonphysical assets, such as patents, trademarks, brand recognition, and copyright; their valuation is sometimes subjective.
- **Patent** A license granted by a government or authority giving the owner exclusive rights for making or owning an invention

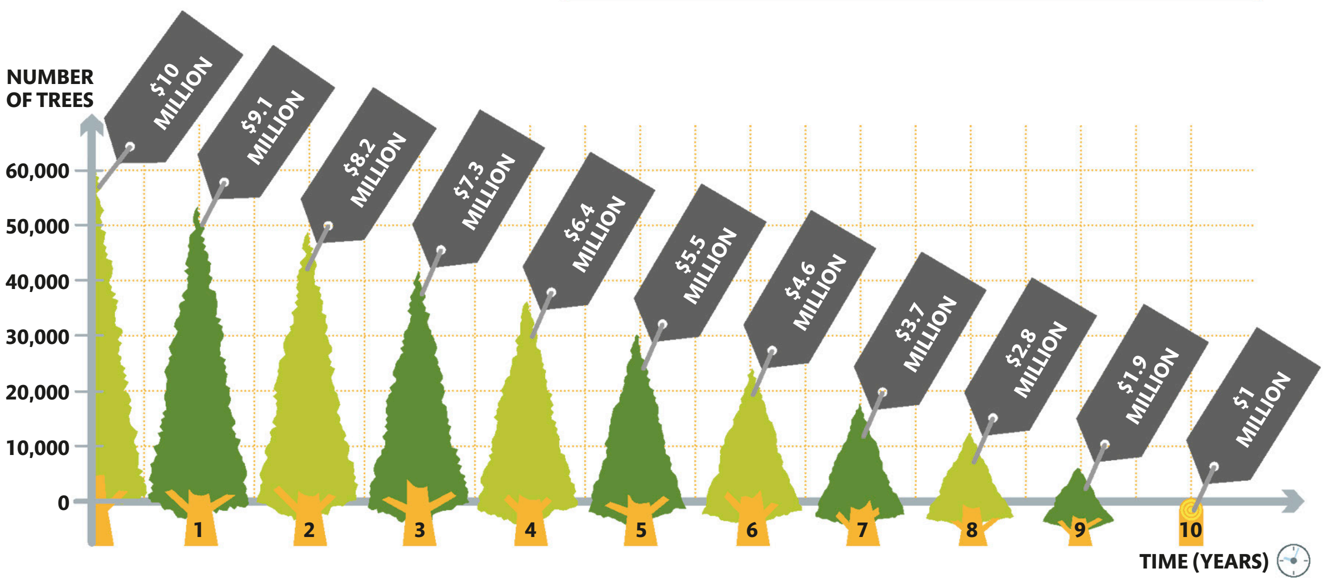
How to calculate depletion

Like amortization, depletion is calculated by using the straight-line method (*see pp.124–125*), unless there is a particular reason to use another method.

In this example, a logging company buys a forest with an estimated 60,000 trees for $10 million. The original salvage value is $1.5 million, but the company spends $500,000 on building roads in the forest, bringing it down to $1 million. The company cuts down 6,000 trees during each accounting period.

$$\frac{\text{COST – SALVAGE VALUE}}{\text{TOTAL UNITS}} \times \text{UNITS EXTRACTED} = \text{DEPLETION EXPENSE}$$

$$\frac{10{,}000{,}000 - 1{,}000{,}000}{60{,}000} \times 6{,}000 = \$900{,}000$$



Management accounting

For a company's management to anticipate profit and loss, plan cash flow, and set effective goals for the business, the coming year's incomings and outgoings need to be documented in detail. Unlike financial accounting, which is primarily for external users, such as investors, lenders, or regulators, management or cost accounting takes place within a business to project expected sales revenue and expenses so that the business can decide how to best use its available resources.

Management accounting process

Planning is done for the financial (fiscal) year that lies ahead—this is also called the accounting year and is made up of 12 consecutive months. Start and end dates differ from country to country.

Department budgets

Managers estimate what funds will be needed for expected expenses. *See pp.136–137*.

Purchase orders (POs)

POs tell the finance department exactly how much money to reserve for payments.

Timesheets

Staff employed on an hourly or daily basis fill in timesheets; these help managers calculate overall staff costs. *See pp.140–141*.

Invoices

Invoices submitted by contractors and suppliers have to be matched against purchase orders and paid. *See pp.134–135*.

Goods received

Employees log receipt of merchandise, describing the goods or services and the quantity received.

Management

Managers create budgets and document business costs to monitor business performance and plan for the short and medium term. The information they collect sheds light on the financial implications of ongoing projects.

Information is passed to finance department.

$157 billion

combined revenue of the Big Four accounting firms* in 2020

* Deloitte, PwC, Ernst & Young, and KPMG

COST ACCOUNTING PRINCIPLES

The Chartered Institute of Management Accounting (CIMA) in the UK and the American Institute of Certified Public Accountants (AICPA), with members in 177 countries, have established Global Management Accounting Principles.

- **Communication provides insight that is influential.** Facilitate good decision making through discussion.
- **Information is relevant.** Source best material.
- **Stewardship builds trust.** Protect financial and nonfinancial assets, reputation, and value of organization.
- **Impact on value is analyzed.** Develop models to demonstrate outcomes in different scenarios.

Cost of production report (CPR)

CPR shows all the costs that can be charged to a particular department. *See pp.140–143.*

Budget reports

Reports help management determine the accuracy of budgets and analyze business performance. *See pp.136–137.*

Cash-flow statement

This shows how well the business will be able to meet its financial obligations and generate cash in the future. *See pp.120–121.*

Balance sheet

The balance sheet estimates the value of assets and inventory held so that management can reduce it, if necessary. *See pp.116–117.*

Profit-and-loss statement

Also called an income statement, the P&L statement tells management how much money the business made or lost over a particular time period. *See pp.114–115.*

Financial analysis is passed to managers.

Finance department

Accountants in the finance department (or contracted from outside the business) receive information about the costs from managers. They then use these figures to generate reports and statements for the managers, who use this information to make decisions for the next financial year.

Cash flow

The money coming in and going out of a business is its cash flow; the balance of inflow and outflow is key to survival. Inflows arise from financing, operations, and investment, while outflows are expenses.

Sales revenue

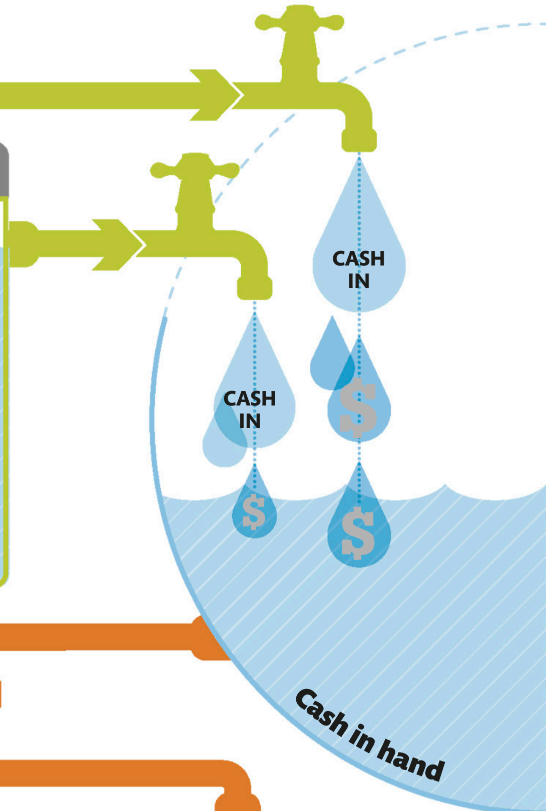
Cash for goods and services sold

- Revenue generated by core operations
- Basis of profit—does not have to be repaid, unlike loans or capital
- Company must be able to turn revenue into cash (get paid) to maintain cash flow
- Also known as cash flow from operating activities

Capital

Investment and lump sums

- Main source of cash inflow for start-ups
- Additional cash injection after initial start-up or at key stages in a company's growth
- Revenue from flotation of private companies (going public) and shares issued by public companies
- Also known as cash flow from investing activities



CASH OUT

"The three most dreaded words in the English language are 'negative cash flow.'"

David Tang, entrepreneur, 2011

Salaries and wages

Payments to employees

- Money paid to employees who are directly involved in the creation of goods or provision of services
- Salaries paid to staff as a fixed amount monthly or weekly (based on an annual rate)
- Wages paid to contractors for hours, days, or weeks worked

Overheads

Payment of bills

- Day-to-day running costs
- Rental cost of commercial property; utility bills—water, electricity, gas, telephone, and Internet; office supplies and stationery
- Salaries and wages of employees not directly involved in creating goods and services (known as indirect labor)

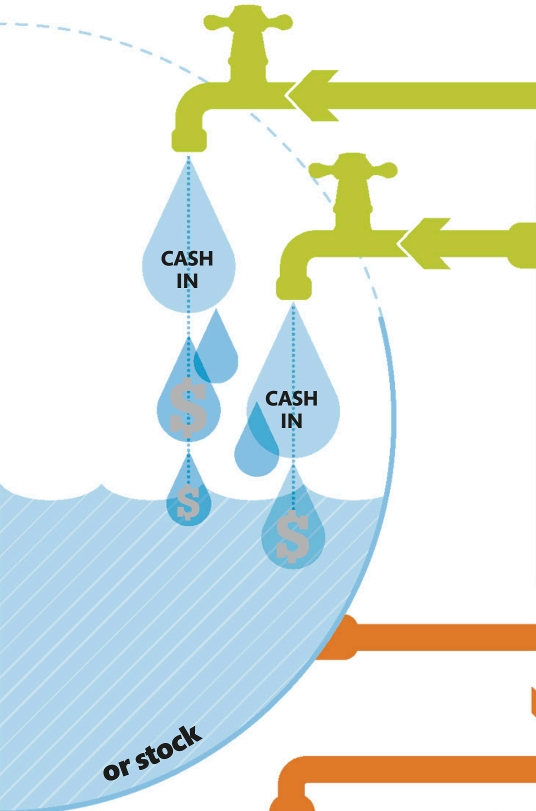
Loan repayments

Debt servicing and shareholder profit

- Interest on long-term loans for asset purchases and on short-term loans for working capital
- Repayments on capital loans
- Commission paid to factoring companies
- Cash distribution to shareholders via share repurchases and dividend payments

How it works

Cash flow is the movement of cash in and out of a business over a set period of time. Cash flows in from sales of goods and services, loans, capital investment, and other sources. Cash flows out to pay employees, rent and utilities, suppliers, and interest on loans. Timing is key—having enough cash coming in to pay bills on time keeps the company solvent.



Other revenue

Grants, donations, and windfalls

- Grants from the government or other institutions, usually one-time sums for research and development
- Donations and gifts (applicable to nonprofit organizations)
- Sales of assets and investments
- Repayment of loans made to other organizations
- Tax refunds

Loans

Bank loans and overdrafts

- Working capital loans to meet shortfalls, with anticipated inflows as collateral
- Advances on sales invoices from factoring companies
- Short-term overdrafts
- Also known as cash flow from financing activities

Suppliers

Payments for materials and services

- Cost of raw materials needed to manufacture goods for sale
- Cost of stock, imported or local
- Fees for services, such as consulting or advertising, to generate revenue
- Payments to contractors involved in goods and services creation

Tax

Payments to tax authorities

- Corporation tax based on annual financial statements
- Payroll tax paid by employers on behalf of employees
- Sales tax on goods or services
- Vary from country to country, depending on tax law

Equipment

Purchase of fixed assets

- Cost of buildings and equipment, such as computers and phones, office furniture, vehicles, plants, and machinery
- Offset by depreciation (*see pp.124–127*)

Cash-flow management

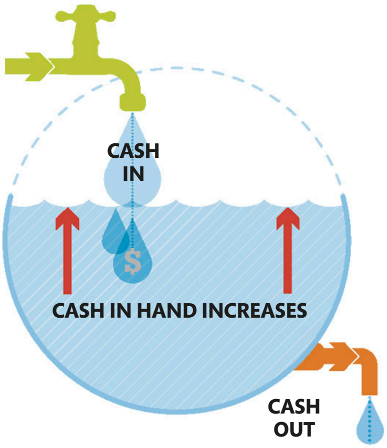
The handling of cash flow determines the survival of any business. Equally important is a company's ability to convert its earnings into cash, which is known as liquidity. No matter how profitable a business is, it may become insolvent if it cannot pay its bills on time. New businesses may become victims of their own success and fail through "insolvency by overtrading" if, for example, they spend too much on expansion before payments start coming in and run out of cash to pay debts and liabilities. In order to manage cash flow, it is essential for companies to forecast cash inflows and outflows. Sales predictions and cash conversion rates are important. A schedule of when payments are due from customers, and when a business has to pay its own salaries, bills, suppliers, debts, and other costs, can help predict shortfalls. If cash flow is mismanaged, a business may have to pay out before receiving payment, leading to cash shortages. Some businesses, such as supermarkets, receive stock on credit but are paid in cash, generating a cash surplus.

WARNING

Top five cash-flow problems

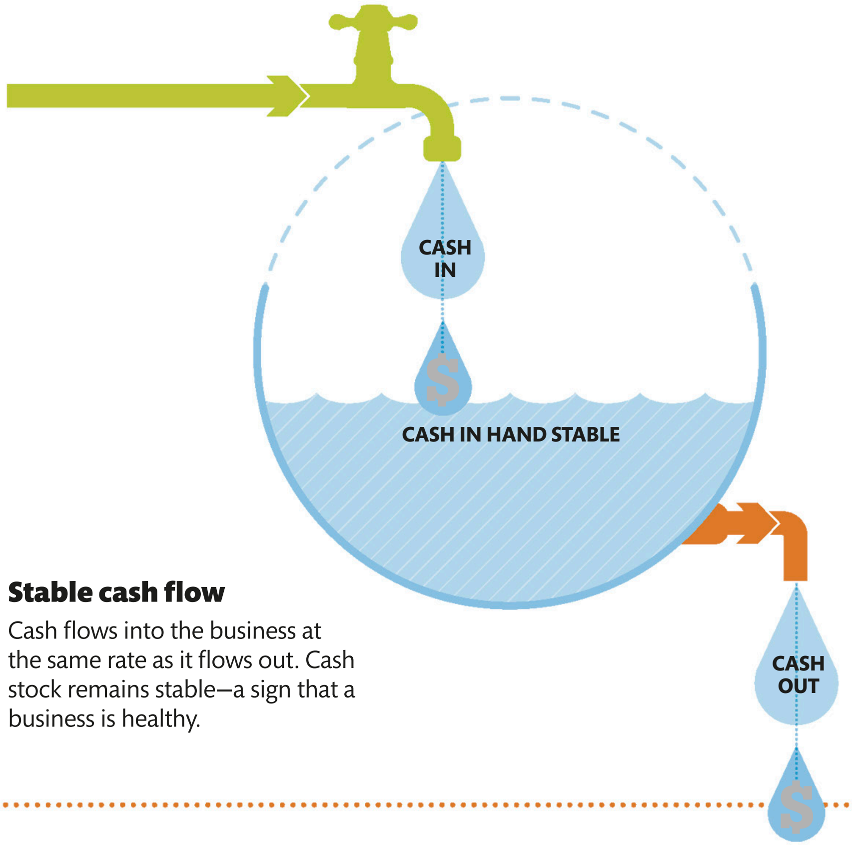
- **Slow payment** of invoices
- **Credit terms** on sales invoices set at 60 or 120 days, while credit terms on outgoings are 30 days
- **Decline in sales** due to change in economic climate or competition or product becoming outdated
- **Underpriced product,** especially in start-ups trying to compete
- **Excessive outlay** on payroll and overhead costs; buying rather than renting assets

Positive and negative cash flow



Positive cash flow

Cash flowing into the business is greater than cash flowing out. Cash in the tank—stock—increases. A business in this position is thriving.



Stable cash flow

Cash flows into the business at the same rate as it flows out. Cash stock remains stable—a sign that a business is healthy.

NEED TO KNOW

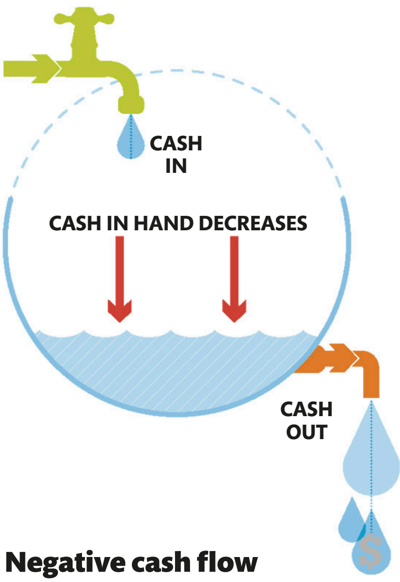
- **Factoring** Transaction in which a business passes its invoices to a third party (factor), which collects payment from the customer for a commission
- **Accounts payable** Payments a business has to make to others
- **Accounts receivable** Payments a business is due to receive
- **Aging schedule** A table charting accounts payable and accounts receivable according to their dates
- **Cash-flow gap** Interval between payments made and received

Cash conversion

Successful businesses convert their product or service into cash inflows before their bills are due. To make the conversion process more efficient, a business may speed up:

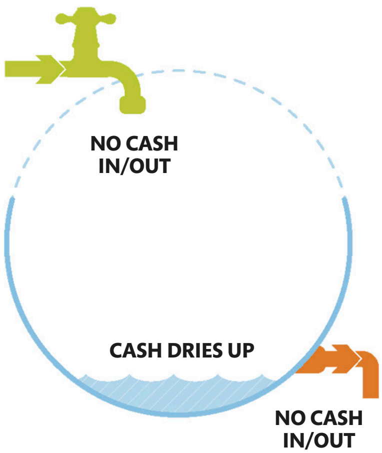
- Customer purchase ordering
- Order fulfillment and shipping
- Customer invoicing
- Accounts receivable collection period
- Payment and deposit

76% of global small business owners are concerned about cash flow affecting their growth.



Negative cash flow

Less cash is flowing into the business than is flowing out. Over time, the stock of cash will decrease, and the business will face difficulties.



Bankruptcy

If cash flowing out continues to exceed cash flowing in, cash stock levels will drop so low that the business becomes insolvent.

HANDLING THE FLOW

Managing a surplus

- **Move excess cash** into a bank account where it will earn interest or make profitable investments.
- **Use cash** to upgrade equipment to improve production efficiency.
- **Expand the business** by taking on new staff, developing products, or buying other companies.
- **Pay creditors** early to improve credit ratings or pay down debt before it is due.

Managing a shortage

- **Increase sales** by lowering prices or profit margins by raising them.
- **Issue invoices** promptly and pursue overdue payments.
- **Ask suppliers** to extend credit.
- **Offer discounts** on sales invoices in return for faster payment.
- **Use an overdraft** or short-term loan to pay off pressing expenses.
- **Continue to forecast** cash flow and plan to avert future problems.

Budgets

Setting the budget for a business involves planning the income and expenditures for the accounting year. This is usually broken down by month so the planned budget and actual figures can be compared.

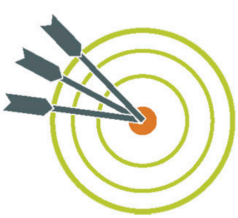
How it works

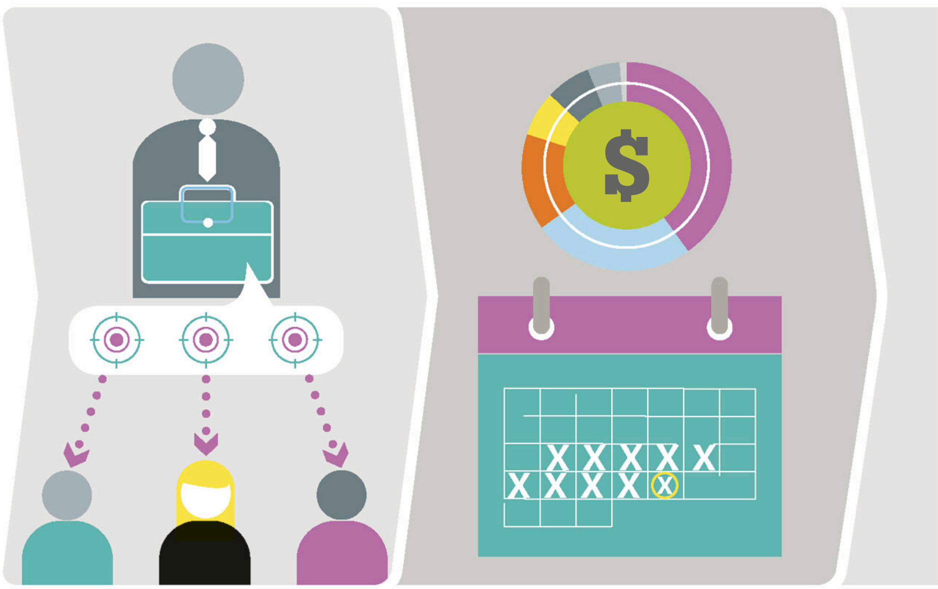
Every business needs to budget for anticipated revenue and operating costs within the financial year. Unlike capital budgeting, in which senior management allocates what will be spent on specific projects or assets, revenue budgeting focuses on the overall projections for money coming in and money going out for each month of the coming financial, or accounting, year. Accountants compile operating budgets from each manager in the business, along with expected cash-flow projections for the business, to create a master budget. The master budget can also include figures for any financing that the company is expected to need over the coming year. As the year progresses, the projected budget and the actual money coming in and going out are monitored on a daily, weekly, or monthly basis so that any deviations from the original budget can be identified, and, if necessary, remedied.

Setting and controlling budgets

Budget setting is a process that takes place between the department managers, senior management, and finance department in a company to establish and control the cost of each department or project.

46% of global firms say their revenue forecasts are accurate to within **5%**.





Consultation

Senior management sets out the company's objectives to the departmental managers. Each manager is then responsible for working out the budget required by their individual department in order to meet those objectives for the coming year.

Prepare the budget

The budget is usually based on the accounting year but broken down into shorter periods. Departmental managers submit their budgets to senior management for approval. These may cover such areas as operating costs (salaries and supplies) and administration (office expenses).

INCREMENTAL AND ZERO-BASED

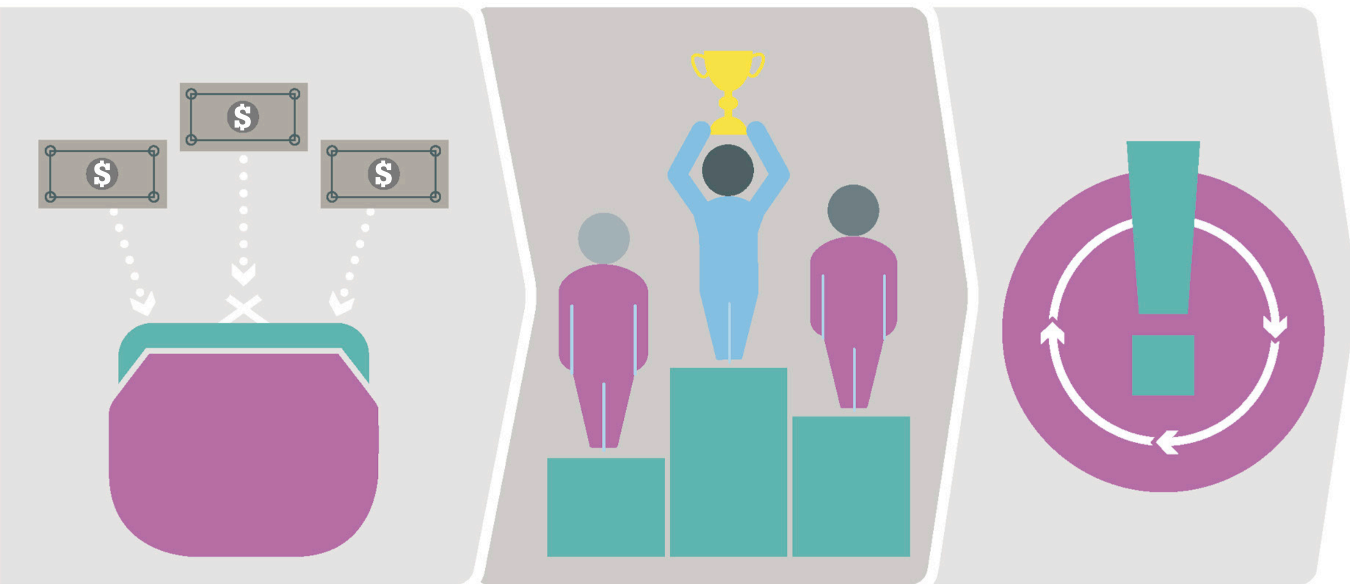
There are two main approaches to setting budgets:

Incremental budget The budget for the year ahead is based on the previous year's budget. This budget takes into account any changes, such as inflation, that could have an impact on the new calculations. The downside is that previous inaccuracies may be carried forward.

Zero-base budget The coming year's budget starts afresh, with no reference to previous years. This means that each item entered into the budget is carefully scrutinized and has to be justified by the department managers. This method makes it easier to see the full cost of all planned changes.

NEED TO KNOW

- **Planning, Programming, and Budgeting Systems (PPBS)** A budgeting system used in public service organizations, such as city councils and hospitals
- **Virement** An amount saved under one cost heading in a budget is transferred to another cost heading to compensate for overspending
- **Budget slack** Deliberately underestimating sales or overestimating expenses in a budget



Master budget

Once approved, the budgets from each department are combined into a master budget for the year, which includes a budgeted profit-and-loss account, a projected balance sheet, and a budgeted cash-flow statement that typically shows a month-by-month breakdown.

Measure performance

After each month (or equivalent time period set in the budget), the actual figures achieved by the company are compared with the original budget projections. Variations are examined closely to identify whether they are significantly different from the figures in the original budget.

Take action

If necessary, the budget is revised to take into account any unforeseen and continued expenditures or any savings that were not anticipated. If income is less than expected, action may be taken to alter departmental processes or campaigns in order to reach the targets set in the budget.

Assets and inventory

A company's possessions, or assets, are divided into two categories: fixed (or long-term) assets and current (or short-term) assets. Current assets consist of cash in the bank and inventory.

How it works

Fixed assets are items that enable a business to operate. They tend to be long-term holdings and cannot be easily converted into cash. Fixed assets can be categorized as either tangible or intangible: tangible assets are material objects, while intangible assets have no physical form.

Current assets are held for the short term and used mainly for trading. The most important category in terms of generating revenue is current assets. The key component of these is inventory. Inventory can be finished goods ready for sale, but it can also be the raw materials that will be used for producing the goods.

NEED TO KNOW

- **Asset valuation** A method of assessing the value of a company's holdings. Asset valuations may take place prior to a merger or the sale of the business or for insurance purposes.

Assets and inventory in practice

The partial balance sheets below show the current assets of a branch of Super Sports Inc., a fictional sportswear and sports accessories company. These assets include cash in the bank and inventory held by the company. The inventory in this case consists of all the items in the shop that are ready for sale.

Super Sports Inc.
May 31

Assets	$
Cash in bank	12,000
Inventory	22,000
Total assets	**34,000**

Balance sheet as of May 31

The "Assets" section of the balance sheet shows that the company holds $22,000 worth of inventory (or goods) at this point in time as well as $12,000 cash in the bank.

Super Sports Inc.
June 15

Assets	$
Cash in bank	54,000
Inventory	0
Total assets	**54,000**

Balance sheet as of June 15

Two weeks later, the company sells all of its inventory for $42,000 and receives payment for this sale on the same day. This means that total assets have risen by $20,000—the profit made on the sale of the inventory—and increases the amount of cash in the bank by $42,000.

TYPES OF INVENTORY

Inventory can include three types of stock, depending on the kind of business being carried out: raw materials, unfinished goods, and finished goods. *See pp.316–317.*

Raw materials

Materials and components scheduled for use in making a product. For example, a chocolate factory will have:

- **Ingredients** in the form of sugar, cocoa mass, cocoa butter, additives, flavorings, and perhaps milk or nuts
- **Foil, plastic, and paper** for the wrappers and packaging

Work in progress

Materials and components that have begun their transformation into finished goods; these may be referred to as "unfinished goods." For instance, a graphic designer will have:

- **Layouts and designs** that are being developed and are awaiting client approval

Finished goods

The stock of completed products or goods ready for sale to customers. A bookstore, for example, will have:

- **Hardback and paperback books** of various genres and formats supplied by publishing houses
- **Gift items**, such as greeting cards and notebooks

Types of fixed assets

Super Sports Inc. owns a range of tangible and intangible fixed assets. Compared to tangible fixed assets, the worth of intangible fixed assets can sometimes be harder to evaluate.

Tangible fixed assets

Retail outlets plus company headquarters

Store displays and back office furniture

Computers and other IT devices and components

Trucks and branded company cars

Warehouse and distribution equipment

Intangible fixed assets

Brands and designs, creative innovation

Legally protected words and symbols

Brands, including value and luxury lines

Internet portal for online sales

Licensing revenue streams

Costs

Costs are the direct or indirect expenses that a business incurs in order to carry out activities that earn revenue, such as manufacturing goods or providing a service.

How it works

There are two main ways of classifying costs: variable costs, which increase as output increases, and fixed costs, which remain constant; direct and indirect costs, which contribute directly or indirectly to the overall running of the business, can either vary with the level of production or stay fixed. There are three main costs that businesses need to account for. The first is labor—wages paid to people employed to carry out a particular task. Labor can be regarded as a direct cost or overhead or as variable or fixed. The second is the raw materials used in production and other materials used in service industries—these costs are variable. The third is expenses, which are other costs incurred in the course of the business's activities.

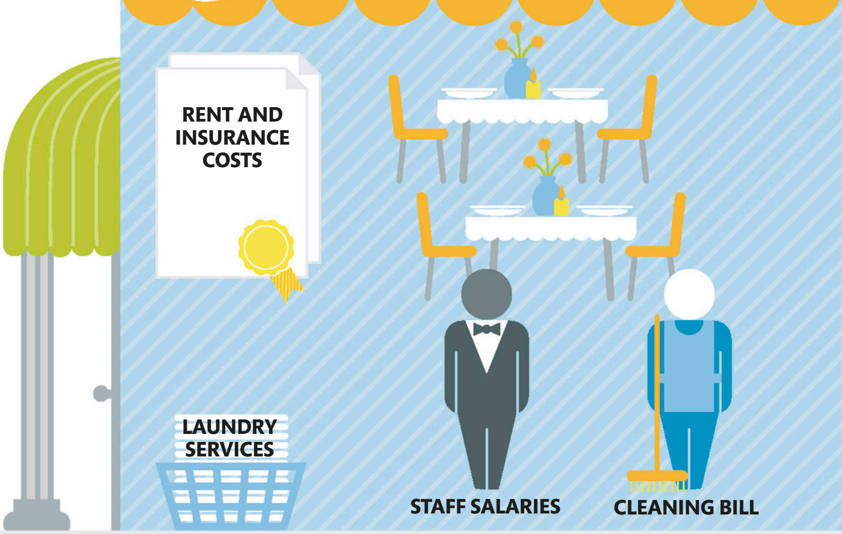
Variable costs

The head chef orders the ingredients that will be required each day. For peak evenings, the cost of the food order is higher; for quieter nights, the food order is lower.

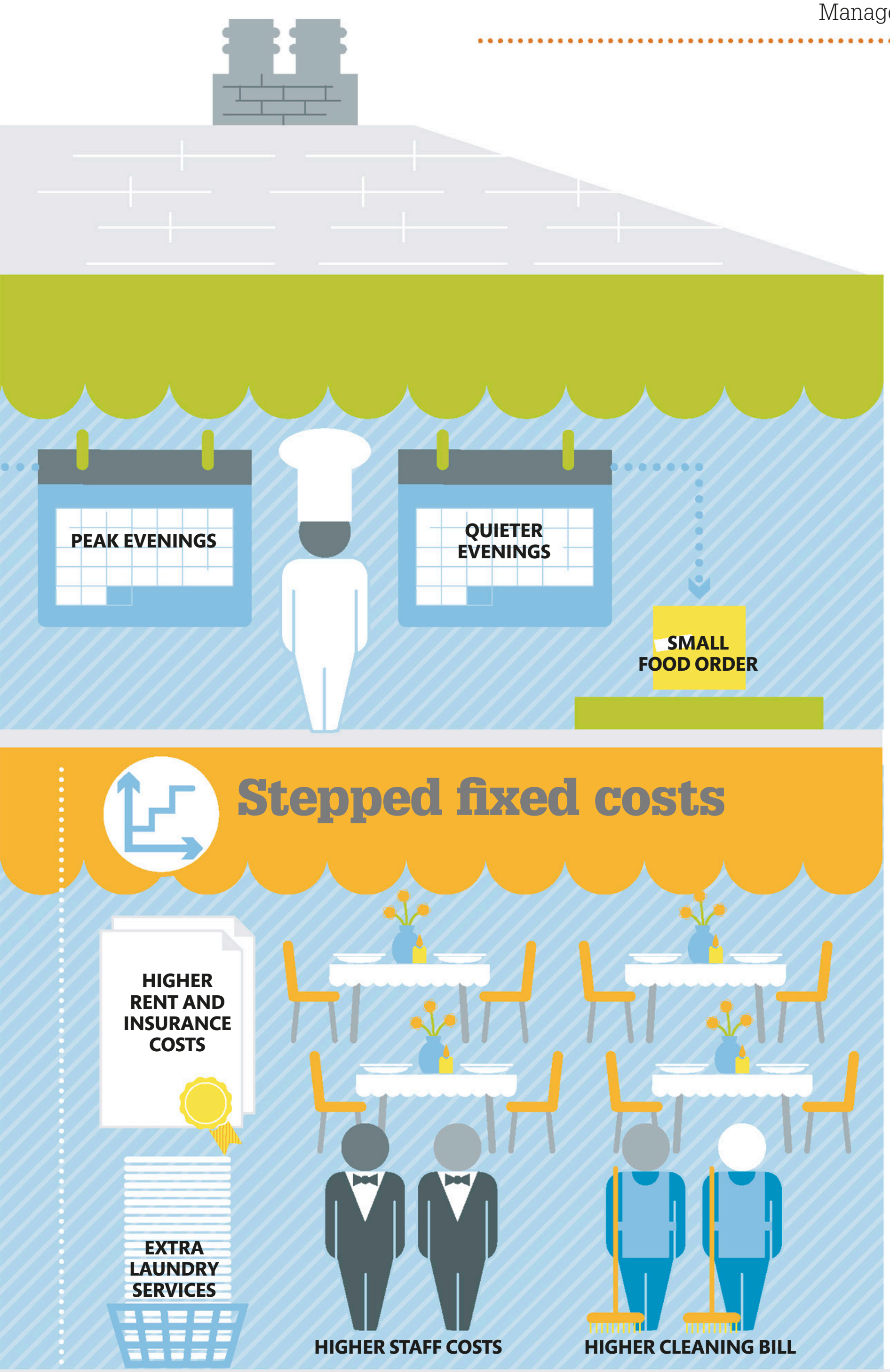
Fixed and variable costs

One way of looking at costs is to split them into two categories: fixed costs, which do not change with the level of business activity, and variable costs, which do change with the level of business activity. This helps accountants determine how changes in business activity (for example, cutting or increasing production) will affect costs. In reality, some fixed costs will increase once business activity reaches a certain level—these are called stepped fixed costs.

Fixed costs



A restaurant rents a building to serve 40 diners. The fixed costs are the same whether the restaurant serves 30 or 40 diners a night.



The restaurant becomes popular, so the owner rents the space next door to serve an additional 40 diners each night. The costs that were fixed at a certain level have now doubled.

NEED TO KNOW

- **Break-even point (BEP)** The point at which total sales revenue is equal to total costs
- **Questionable costs** Costs that can be treated as fixed or variable
- **Sunk costs** Costs incurred in the past that cannot be recovered
- **Prospective costs** Costs that may be incurred in the future, depending on the business decisions made

€28.5

the average hourly labour cost in the EU in 2020

Product costing and pricing

Knowing the full cost of creating each product that a business sells is vital because it helps a company price its products appropriately and assess the performance of the business.

How it works

Both direct and indirect costs contribute to the production cost of a product, whether it is a manufactured good or a service being provided. In order to calculate the cost of a product, it is treated as one unit of production. The direct and indirect costs involved in creating that single unit are then assessed and added together to create the full cost.

25%

the average net profit margin in the banking sector. In food retail, the average is 2%.

NEED TO KNOW

- **Absorption costing** Allocation of all production costs to product
- **Differential costing** Difference between the costs of two options
- **Incremental (marginal) costing** The change in total costs incurred when one additional unit is made
- **Throughput costing** Treating all costs except for direct materials as period expenses
- **Cost-plus pricing** Product price is based on direct and indirect costs, plus markup percentage.

Full cost pricing

Direct costs can be measured in terms of how materials and labor are used to produce each unit. Indirect costs (overheads) are harder to assess but also need to be factored in so that the full cost of each product can be calculated. Managers and accountants must apportion indirect costs to reflect their contribution to the cost of creating a single product. Once this is ascertained, the full cost of that product can be determined. In general terms, the price is worked out by adding the direct and indirect costs of production with a profit margin that gives an appropriate selling price.

Direct costs

- Materials
- Direct labor
- Direct expenses
- All used exclusively to create a product or service for sale

+

Share of indirect costs

- Production and service overheads
- Administrative and management overheads
- Sales and distribution overheads

OTHER COSTING METHODS

There are several different approaches to costing and pricing, depending on the industry, the type and size of the business, and the method of production.

JOB COSTING
Used for a customized order made to a client's specifications—for example, a printing company that prints brochures for a client

BATCH COSTING
Used when a batch of identical products is made—for example, an electrical goods company manufacturing television sets

CONTRACT COSTING
Used for a large one-time job, often the result of a tender process (when a company bids for work) and carried out at the client's site—for example, a construction company building homes in a new residential development

PROCESS COSTING
Used for an ongoing job that often involves several manufacturing processes, making it difficult to isolate individual unit costs—for example, an oil refinery that processes crude oil into diesel oil

SERVICE COSTING
Used when the product being sold is a standard service offered to customers—for example, a nail salon offering an express manicure and pedicure within a set period of time and for a fixed price

Profit margin

- Must be able to generate profit for the company
- Must be in line with how the product has been marketed
- Must be pitched realistically so that customers will buy

Selling price

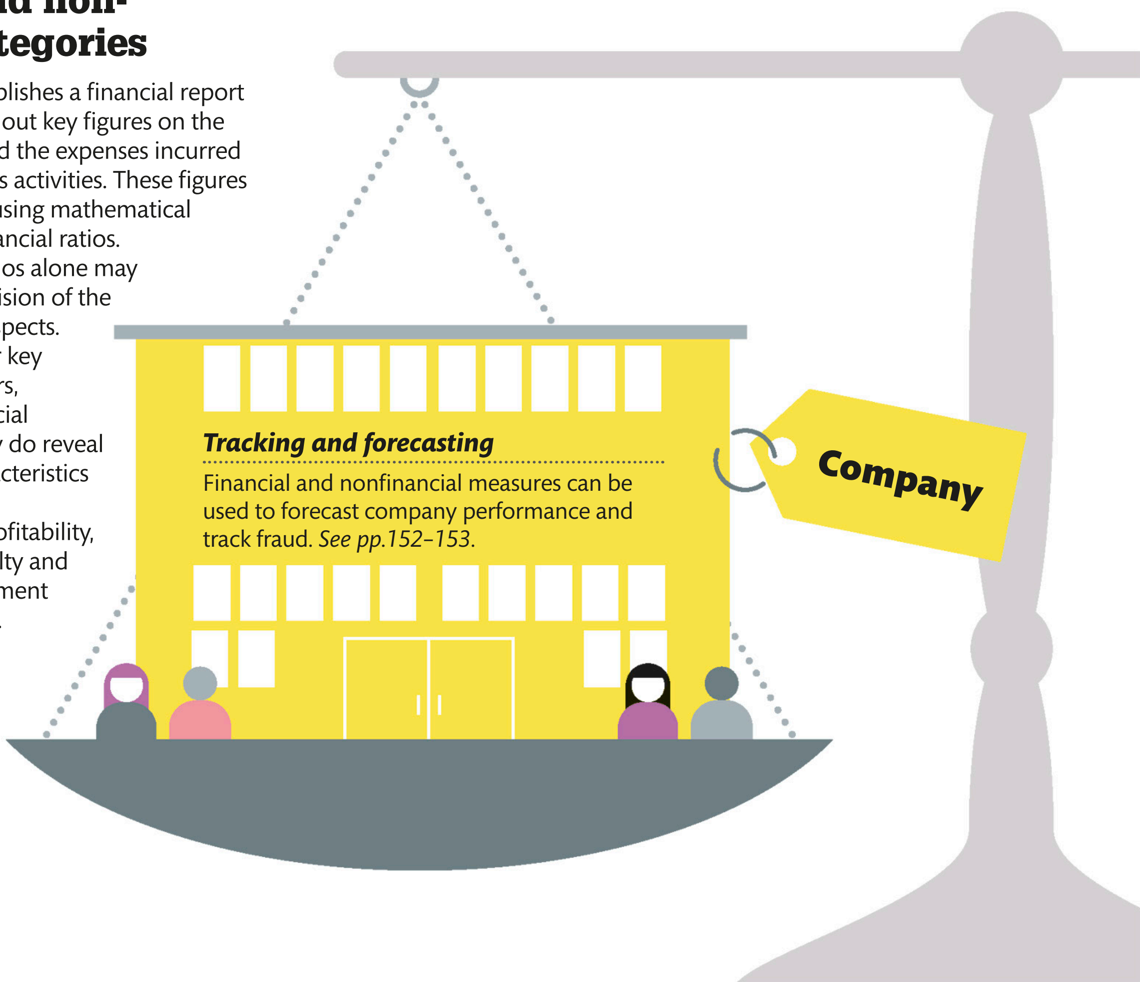
- Low: in order to gain market share or to match competitors
- Cost-based: recover direct and indirect costs and profit margin that the market will accept
- Service-based: flexible because no manufacturing or distribution cost

Measuring performance

There are two main ways of measuring a company's performance: financial and nonfinancial. To assess financial performance, a company calculates financial ratios. To assess other areas of the business, a company examines its key performance indicators (KPIs), which help management and staff evaluate performance and how it can improve. KPIs also help interested outsiders, such as investors, lenders, or analysts, decide whether to invest in the business.

Financial and non-financial categories

Any company that publishes a financial report will be required to set out key figures on the revenue generated and the expenses incurred during the course of its activities. These figures can be compared by using mathematical calculations called financial ratios. However, financial ratios alone may not give an accurate vision of the company's future prospects. Nonfinancial ratios, or key performance indicators, do not measure financial performance, but they do reveal other important characteristics of a company that will ultimately affect its profitability, such as customer loyalty and research and development (R and D) productivity.



Tracking and forecasting

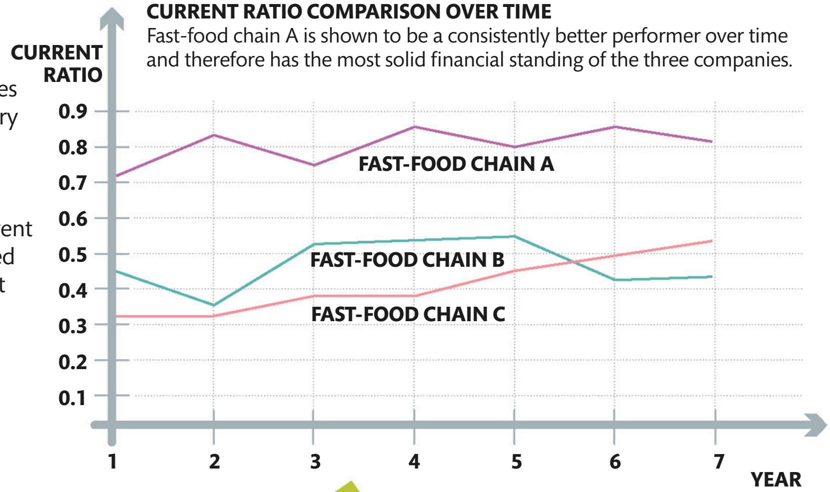
Financial and nonfinancial measures can be used to forecast company performance and track fraud. *See pp.152–153.*

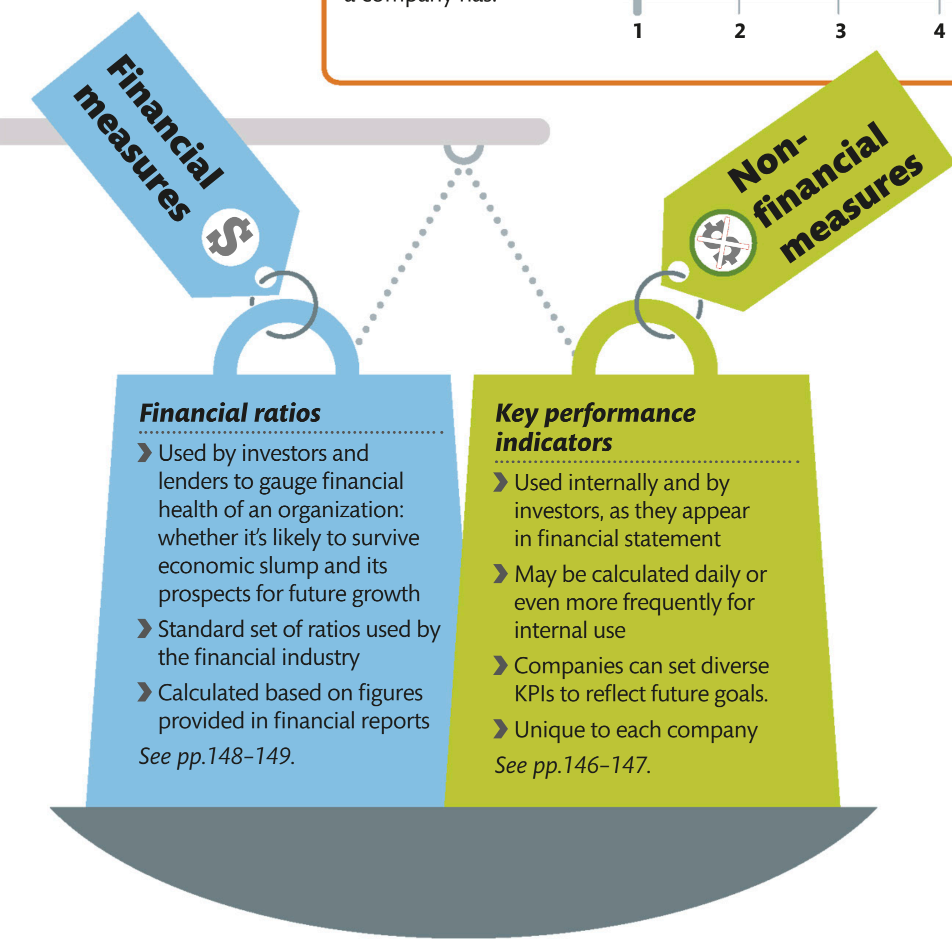
TREND ANALYSIS USING PERFORMANCE MEASUREMENTS

A comparison of either financial ratios or KPIs between companies in the same industry and across time is often used to track a company's performance. Current ratios are calculated by dividing current assets by current liabilities: the higher the ratio, the more liquidity a company has.

CURRENT RATIO COMPARISON OVER TIME

Fast-food chain A is shown to be a consistently better performer over time and therefore has the most solid financial standing of the three companies.





Financial ratios

- Used by investors and lenders to gauge financial health of an organization: whether it's likely to survive economic slump and its prospects for future growth
- Standard set of ratios used by the financial industry
- Calculated based on figures provided in financial reports

See pp.148–149.

Key performance indicators

- Used internally and by investors, as they appear in financial statement
- May be calculated daily or even more frequently for internal use
- Companies can set diverse KPIs to reflect future goals.
- Unique to each company

See pp.146–147.

THE BIGGER PICTURE

Some professional bodies and services companies, such as the UK's CBI and multinational PwC, conduct regular surveys, interviewing senior executives to find out how optimistic they are about their sector and the wider economy. Such surveys help companies measure their own performances objectively.

4–10

KPIs are likely to be crucial for most companies.

Key performance indicators (KPIs)

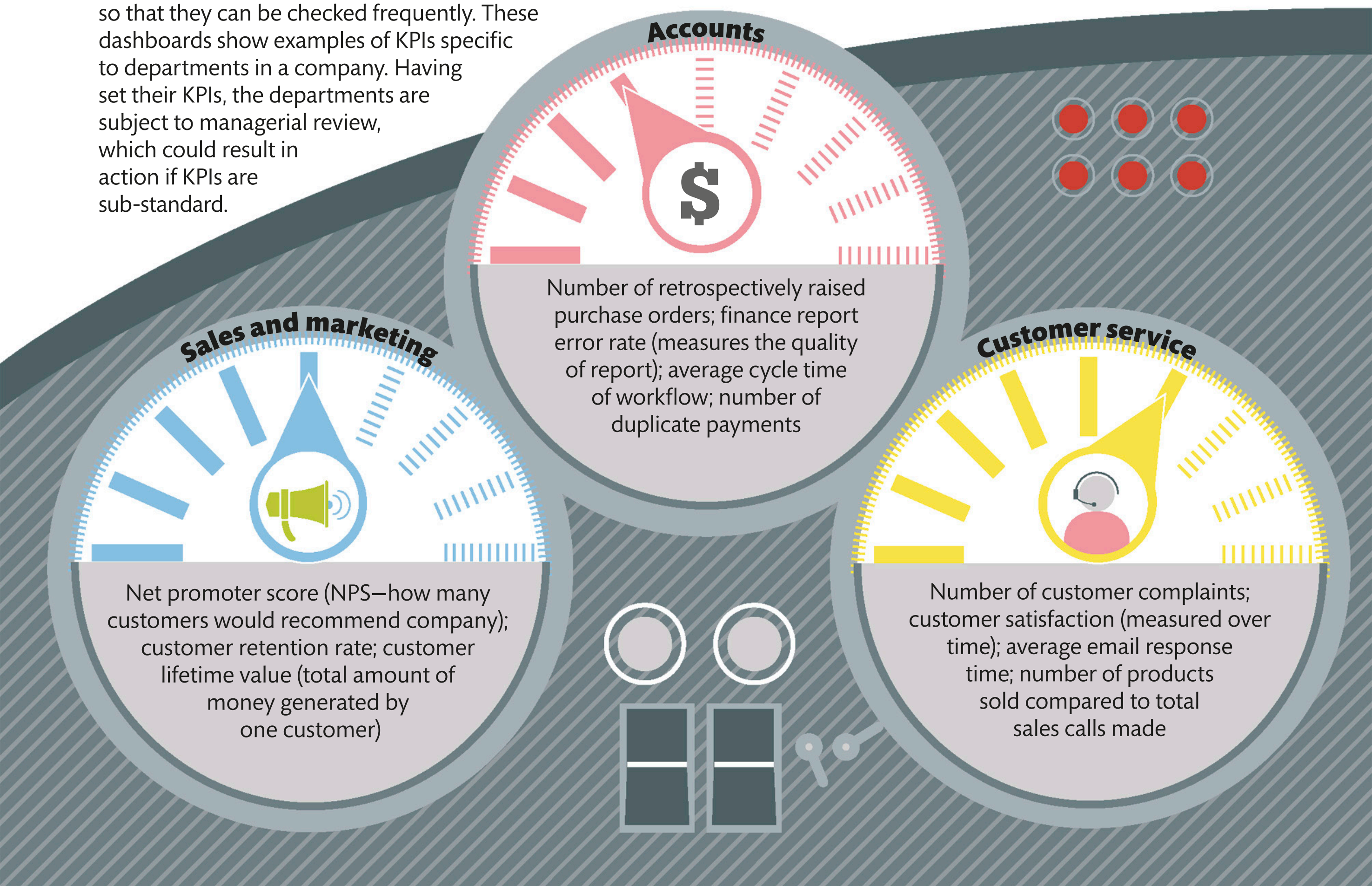
Key performance indicators (KPIs), or key success indicators (KSIs), are based on a company's goals and vary depending on the company and industry. KPIs are usually stated in a company's annual report.

How it works

KPIs are the non-financial measures of a company's performance—they do not have a monetary value but they do contribute to the company's profitability. Any company department can adopt KPIs to gauge its performance. A KPI for an accounts department might be the percentage of overdue invoices, as this will help determine the department's efficiency. This is an example of a lagging indicator—it is an outcome and therefore easy to measure, but not straightforward to influence. Companies also look for leading indicators, which are focused on inputs and easier to change. A leading KPI for the accounts department might be the percentage of purchase orders raised in advance.

Corporate KPIs

KPIs can be set up as dashboards on computers so that they can be checked frequently. These dashboards show examples of KPIs specific to departments in a company. Having set their KPIs, the departments are subject to managerial review, which could result in action if KPIs are sub-standard.

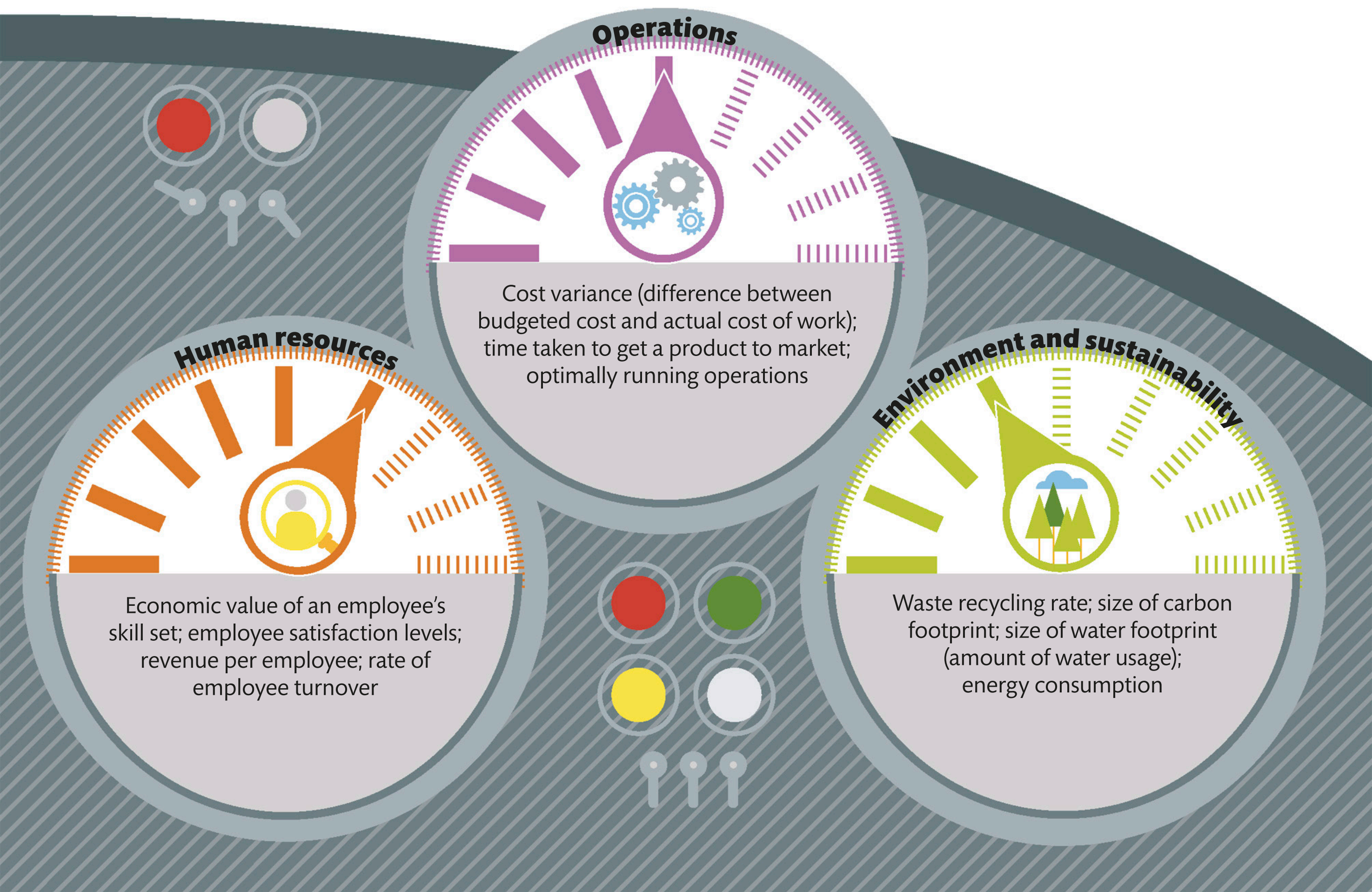


93% of companies say their **Balanced Scorecard** is extremely or very helpful

BALANCED SCORECARD SYSTEM

This strategic system offers a different way of monitoring a company's performance, presenting a more balanced view rather than one solely focused on financial results. It was proposed by Robert Kaplan and David Norton at the Harvard Business School in the 1990s, and over 50 percent of large companies in the US, Europe, and Asia use the approach. The Balanced Scorecard consists of four ways to view an organization's performance:

- **Learning and growth** Employee training and corporate culture
- **Business processes** Includes specific measurements for monitoring daily performance
- **Customer perspective** Customer satisfaction
- **Financial perspective** Traditional financial data



Financial ratios

Lenders, investors, analysts, internal management, and other interested parties calculate financial ratios to decipher what financial statements are really saying about the state of a business.

How it works

Financial ratios are used to assess the financial standing of a business and identify any problem areas that might affect its future prospects. The process involves comparing two related items in the financial statement, such as net sales to net worth or net income to net sales, and using those ratios to measure the relative performance of the company. There are many different ratios to choose from, depending on the purpose—for example, whether the purpose is to measure the company's ability to provide a good return to shareholders, its capacity to handle debt, or the efficiency with which it operates. The ratios can also be used to compare a business with its competitors or in comparison to specific benchmarks within the company to determine how consistent its financial results are.

Top financial ratios

These are some of the ratios most commonly used by people involved with assessing businesses. They are best considered comparatively and in the context of the economic climate. The ratios are for analyzing established companies, usually public ones with shares traded on the stock exchange—start-ups and small-to-medium enterprises generally do not have a full enough range of figures to provide any kind of reliable guide.

Profitability ratios

These are used to see how effective a company is at generating profit. Profitability ratios may mirror investment valuation ratios. One example is the operating profit margin ratio. A high ratio is good, as it indicates a high proportion of revenue (gross income) converted into operating income (profit minus costs).

$$\text{OPERATING PROFIT MARGIN} = \frac{\text{OPERATING INCOME}}{\text{REVENUE}}$$

Other profitability ratios

- **Return on equity (ROE)** is measured as net income after tax / shareholders' equity. The higher the ratio, the greater the profitability, but not if a company is relying too heavily on borrowing.
- **EBITDA to sales ratio** is measured as EBITDA (earnings before interest, taxes, depreciation, and amortization) / revenue. It gauges the profitability of core business operations. The higher the margin, the greater the profits.

Efficiency ratios

These show how efficiently the company uses its assets and resources to maximize profits. An example is the sales revenue to capital employed ratio, which indicates a company's ability to generate sales revenue by using its assets. Similar ratios can examine how quickly the company settles its bills and invoices.

$$\text{SALES REVENUE TO CAPITAL EMPLOYED RATIO} = \frac{\text{NET SALES}}{\text{CAPITAL EMPLOYED}}$$

Other efficiency ratios

- **Accounts receivable turnover ratio** is measured as net credit sales / average accounts receivable. It shows how efficiently a company turns sales into cash. The higher the ratio, the more frequently money is collected.
- **Inventory turnover ratio** is measured as the cost of goods sold / average inventory. It shows how efficiently a company manages its inventory level. A low ratio usually equates to poor sales.

WARNING

Investors beware

Ratio analysis must be used over time—at least four years—to understand how a company has reached its current position, not just what the position is. For instance, if debt has suddenly gone up, it could be because the company is branching out into new areas of potential profit or to limit the damage of a poor past decision.

10–14%

the minimum return on investment (ROI) needed to fund a company's future

Liquidity ratios

This group of ratios reveals whether a company has enough cash or equivalent assets to meet its debt repayments. An example is the working capital ratio (also a measure of efficiency), which indicates whether a company has enough short-term assets to cover its short-term debt.

$$\text{WORKING CAPITAL} = \frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$$

Other liquidity ratios

- **Cash ratio** is measured as total cash (and equivalents) / current liabilities. It shows whether a company's short-term assets could repay its debts. A high ratio is seen as favorable.
- **Quick ratio (acid-test ratio)** is measured as current assets minus inventories / current liabilities. It shows how easily a company can repay short-term debt from cash. The higher the ratio, the more easily it can pay.

Solvency ratios

While liquidity ratios look at a company's short-term ability to meet loan repayments, solvency ratios indicate the likelihood of a company being able to continue indefinitely with enough cash or current assets to pay its debts in the long run. An example is the debt to equity ratio.

$$\text{DEBT TO EQUITY RATIO} = \frac{\text{TOTAL SHAREHOLDERS' EQUITY}}{\text{TOTAL ASSETS}}$$

Other solvency ratios

- **Interest coverage ratio** is measured as EBIT (earnings before interest and tax) / interest expense. It indicates how easily a company can pay the interest on its debts. The higher the ratio, the more easily it can pay.
- **Debt ratio** is measured as total liabilities / total assets. It indicates the percentage of the company's assets that are financed by debt. A low ratio is considered favorable.

Investment valuation ratios

These ratios are typically used by investors to gauge the returns they are likely to get if they buy shares in a company. An example is the dividend payout ratio. It indicates how well earnings support the dividend payments—more mature companies tend to have a higher payout ratio.

$$\text{DIVIDEND PAYOUT RATIO} = \frac{\text{YEARLY DIVIDEND PER SHARE}}{\text{EARNINGS PER SHARE}}$$

Other investment valuation ratios

- **Net profit margin ratio** is measured as profit after tax / revenue. Another measure of a company's profitability, it is also useful for comparing a company with competitors. The higher the ratio, the more profitable the company.
- **Price to earnings ratio** is measured as market value per share / earnings per share. It indicates the value of the company's shares. A high ratio demonstrates good growth potential.

Forecasting

Predicting future business performance is necessary to estimate probable sales, income, costs, and profitability and thus gain investment and maintain confidence in the company.

How it works

Forecasting success or failure relies on historical data—financial statements, financial ratios, and Key Performance Indicators—that reflect business operation and can be tracked over time. The tracked and monitored data can provide an early warning system for potential problems. For small businesses and start-ups, accurate forecasts provide a basis for raising external

Forecasting with Z-score models

Realizing that traditional financial ratios, such as the ratio of costs to revenue, created only a partial picture of a business's financial performance, Altman devised a set formula that combined four or five key ratios to give a Z score. The model has proven to be 90 percent accurate in predicting business failure over one year and 80 percent accurate over two years.

Working capital / total assets
A measure of liquidity: the more working capital in a company, the more it is able to pay its bills.

Market value of equity / book value of total liabilities
A measure of the market confidence in the company: a ratio of less than one means the firm is worth less than it owes—it is insolvent.

Retained earnings / total assets
A measure of leverage: a high ratio indicates profits are funding growth; a low ratio indicates growth is financed by debt.

Earnings before interest and taxes / total assets
A measure of return on assets: it gauges operating income generated by assets.

Sales / total assets
A measure of efficiency: the sales generated by the assets.

Corporate success
Efficiently run companies with a healthy balance between assets and liabilities and profit and debt inspire confidence in investors.

SS Success

Finding the Z score
Each of the above ratios is multiplied by a specific value to weight them; results are added together to give a Z score.

- A score of 0.2 or lower means the company is highly likely to fail.
- A score of 0.3 or higher means the company is unlikely to fail.

financing, while for larger companies, this information provides an indication of financial strength for investors and markets. There are many different prediction methods and models—the ones you choose will depend on exactly what you want to forecast. One of the most frequently used to predict the chances of a business going bankrupt is the Z-score model, devised by Edward Altman, a New York University finance professor, in 1968.

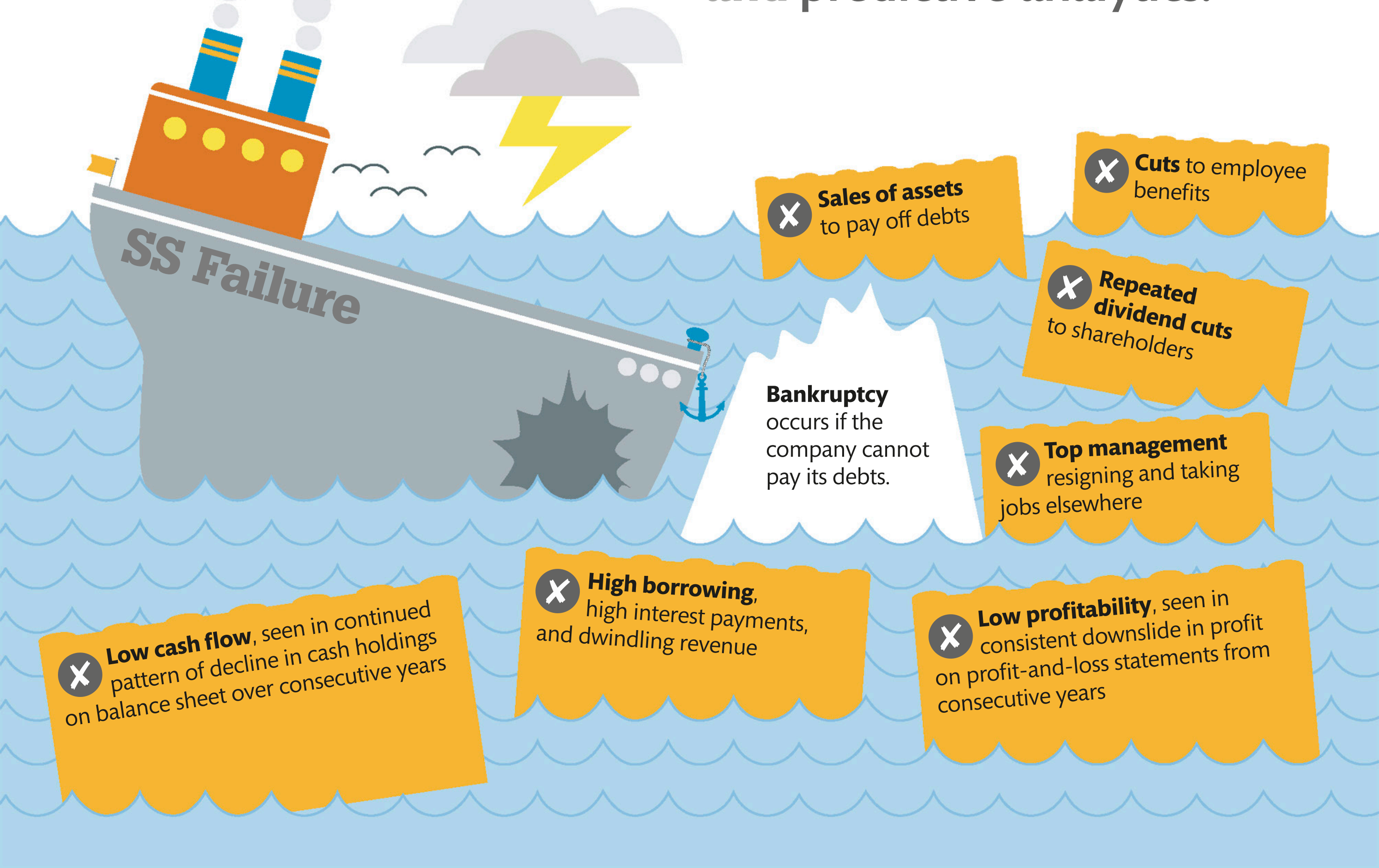
NEED TO KNOW

- **Ohlson O score** Alternative to Z score for predicting failure
- **Overtrading** When a company's sales grow faster than its finance
- **Undertrading** When a company trades at low levels compared to its finance levels
- **Zeta analysis** Second-generation Z-score model

Signs of corporate failure

There are many signs that a company is doing badly and perhaps sliding into insolvency. These signs make investors nervous, which is likely to lower share prices if they start selling their stock. However, most companies that fail are profitable but run out of cash.

59% of organizations say they are now using advanced and predictive analytics.



Tracking fraud

For keen observers of financial statements, warning signs that indicate fraudulent business activities may be detected in overly optimistic statements and evasive attitudes of senior management.

How it works

Public companies are required to have their annual financial statements audited (checked) by an independent auditor. It is typically during this process that any financial shenanigans—creative accounting tricks used to manipulate the figures and improve the performance of a company in its financial statements—and outright fraudulent activity are uncovered. It is the auditor's job to ensure that business records and statements are accurate and have been honestly reported. Auditors carry out a systematic examination of the company's records and may identify any irregularities that may indicate fraud. If evidence of fraud is found, the next step is to involve forensic accountants and criminal investigators, who may prosecute the perpetrators.

NEED TO KNOW

- **Asset stripping** Selling off the assets of a company for a profit to raise funds, often resulting in the closure of the business
- **Tunneling** A particular type of fraud in which assets and funds are illicitly transferred to management or shareholders

Red flags indicating fraud

Auditors may be alerted to fraud by a number of recognized warning signs or "red flags"; these may have directly to do with the behavior of the CEO or other top executives or be in the form of irregularities within the financial statements.

6 the average number of fraud incidents reported per company in the last two years

Suspicious figures on financial statements

- Cash flows that are negative for three quarters and then suddenly and dramatically become positive
- Sudden increase in gross margin, at odds with industry average and company's previous performance pattern
- Large sales to companies with dubious track records
- Sales recorded before they have been made
- Made-up, nonexistent sources of revenue
- Expenses moved from one company to another or classified as assets
- Ongoing, long-term growth of earnings per share
- High payments to executives compared to base salary

How to detect fraud

Procedures should be in place to hold accountable anyone who handles expenses. When these fall short, internal and external auditors need to take more drastic measures.

Applying ratio analysis to reveal key long-term trends (*see pp.148–149*)

LINE-UP: TOP FIVE NOTORIOUS FRAUDS

Some of the worst frauds stem from the most prestigious companies. Enron was one of the top seven U.S. companies, while JPMorgan Chase & Co. was the largest American bank when measured by assets.

SECURITIES EXCHANGE CO.
In 1919, Charles Ponzi began a pyramid scheme in Boston, selling postal reply coupons. He pledged investors 50 percent return within 45 days, which he paid from new investors' funds.

ENRON
Energy company Enron declared bankruptcy in 2001, although it had never shown a loss in its financial statements. External auditors were accused of failing to properly review accounts.

WORLDCOM
U.S. communications company WorldCom declared bankruptcy in 2002 after it improperly accounted for $3.8 billion in expenses. Auditor Arthur Andersen was held liable for not noticing.

JPMORGAN CHASE & CO.
For 10 years from 2002, the company approved thousands of home loans to ineligible recipients. The employee who blew the whistle was awarded $64 million.

WIRECARD
The top German fintech firm filed for insolvency in June 2020 after revealing it was "missing" $2.24 billion. Its collapse sparked questions over regulators' and auditors' failure to spot the disaster.

CEO behavior

- Evasive behavior by executives over important financial details
- Attempts by CEO to steer auditors away from certain documents

Technicalities

- Late entry of sales or earnings adjustments
- Missing approvals or signatures

Setting up confidential hotline for current and past employees or others with knowledge of the company

Using the element of surprise, such as undertaking an aggressive internal audit without prior warning

Conducting a surprise cash count to determine whether current cash flow matches statements

Data mining with auditing software to detect any mismatch between past patterns and current statements

Raising financing

When a company needs additional funds, it can use internal or external sources, or both, depending on whether it seeks large amounts of funding for long-term growth, such as an expansion, or smaller amounts for short-term expenses, such as operating costs. In addition, the number of external sources available depends on whether the business is well established or whether it is relatively new and without much of a track record.

Sources of financing and capital

When considering the prospect of raising financing, the financial directors will first evaluate the financial health of the company. They will then decide what proportion of the company will be funded by equity (the company's own reserves of cash and money raised from issuing shares) and what proportion will be funded by borrowing money from an outside source, such as a bank, so that the company takes on debt.

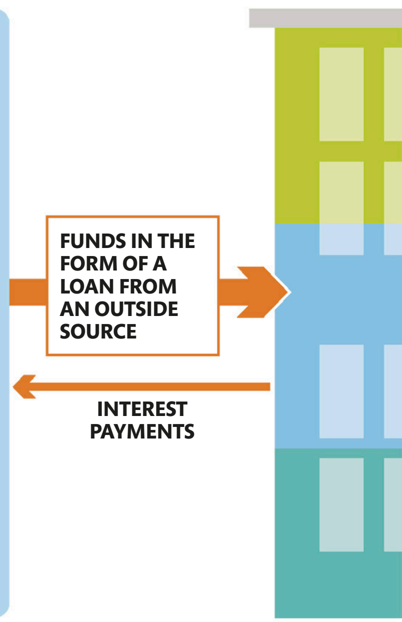
59%

of U.S. financial managers say financial flexibility is the most important factor in deciding how much debt the company takes on.

Debt and loans

Institutional lenders

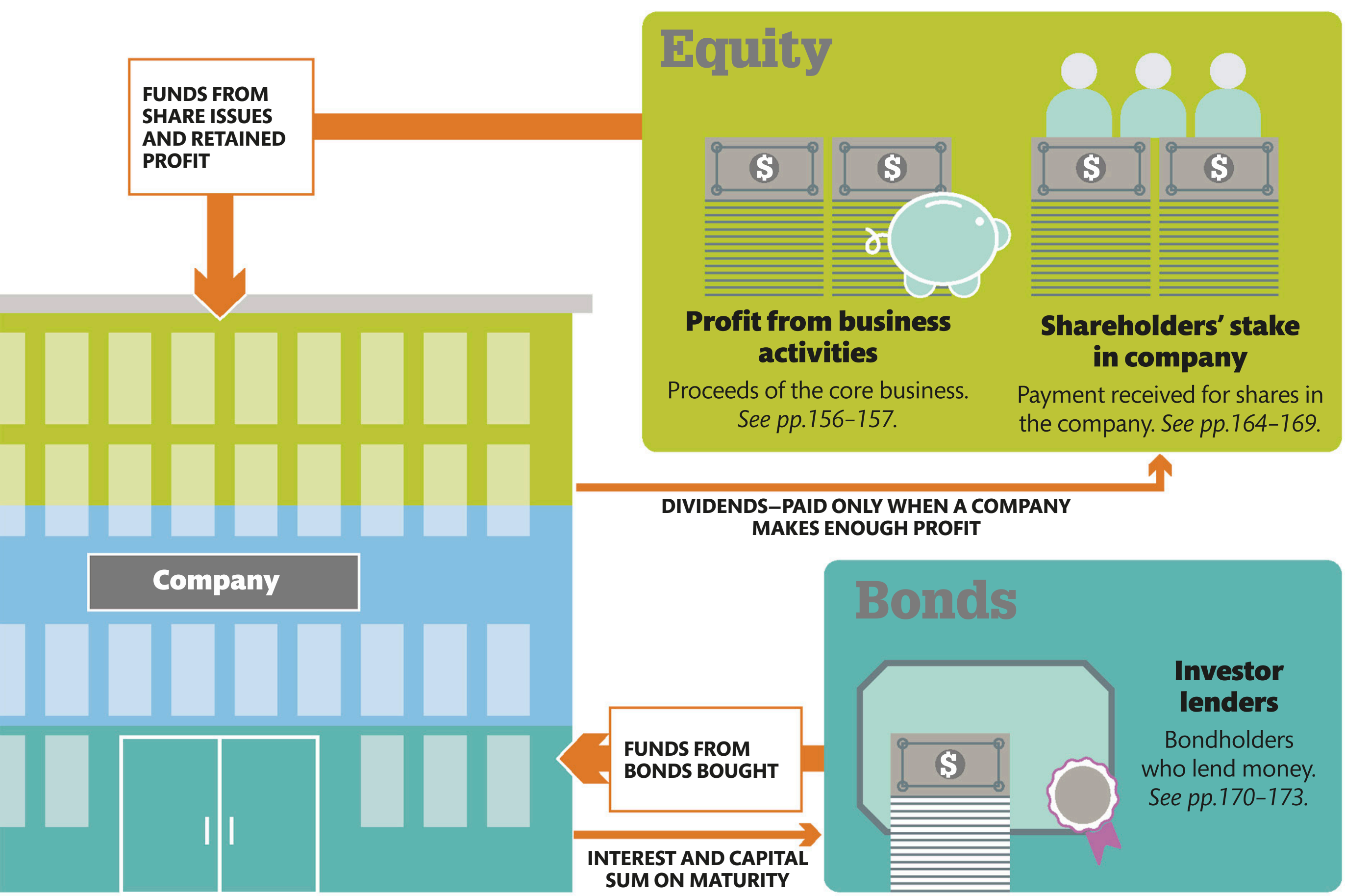
Large financial bodies that lend money, such as banks. *See pp.158–159.*



EVALUATING CAPITAL STRUCTURE

When investors consider buying shares in a company, they look at its capital structure to assess the future prospects of the business. The capital structure refers to the percentage of a company's finances made up of funds from shares and earnings, called equity, and the percentage made up from borrowed funds, or debt. When evaluating capital structure, investors consider the following:

- As a general rule, companies with more equity than debt are considered less risky to invest in because their assets outweigh their liabilities. So, a company with significantly more equity than debt has a low debt-to-equity ratio and is generally seen to be a low-risk investment.
- A company with significantly more debt than equity has a high debt-to-equity ratio and is more risky as an investment.
- Debt is not always bad. If interest rates are low, a company could take on more debt to fund expansion, as long as the revenue it makes from the borrowed funds is greater than the interest payable. So, although this company may be more risky, it may also have greater potential for growth—this is known as "gearing." *See pp.174–175.*



Internal financing

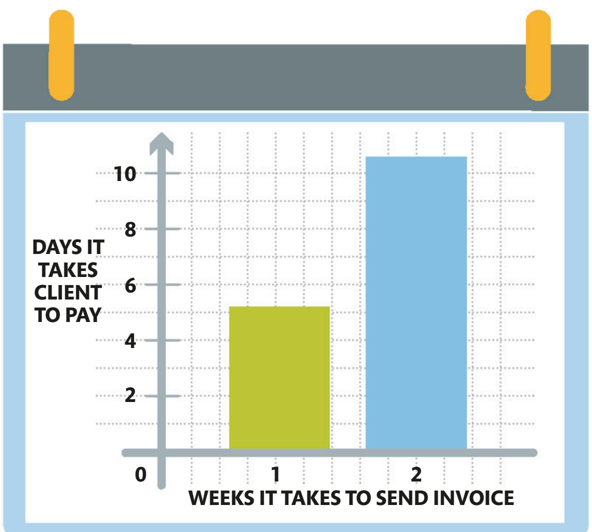
Most companies prefer to secure funding from their own internal resources rather than take on debt through borrowing or give up a stake in the company by issuing shares, both of which cost more.

How it works

When a business needs funds, or capital, to pay for expansion or investment in order to maintain its current operations, it is faced with two choices: either find the money from outside sources or find the money from within the organization itself. Because there are costs attached to bringing in funds from external sources, such as interest that has to be paid on a bank loan, the business managers must weigh the opportunity cost of using the company's own funds—the profit it could earn by investing those funds—against the cost of financing.

THE RECENCY BIAS

When a company receives timely payments for its invoices, this helps maintain its levels of funds. Interestingly, invoices issued right after completion of work tend to get paid sooner than those invoices that are sent later. A theory called recency bias explains this phenomenon: the brain prioritizes recent events over those that occurred longer ago.

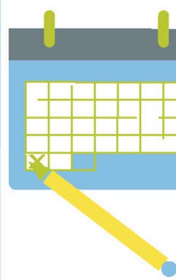


Raising internal financing

Whether a company's need for additional funds is long or short term, steps can be taken to increase the level of funds within the company.

Short-term financing

For businesses wishing to raise funds without resorting to external sources, there are three main strategies they can implement to maximize the amount of cash available for day-to-day operations and capital expenditure.

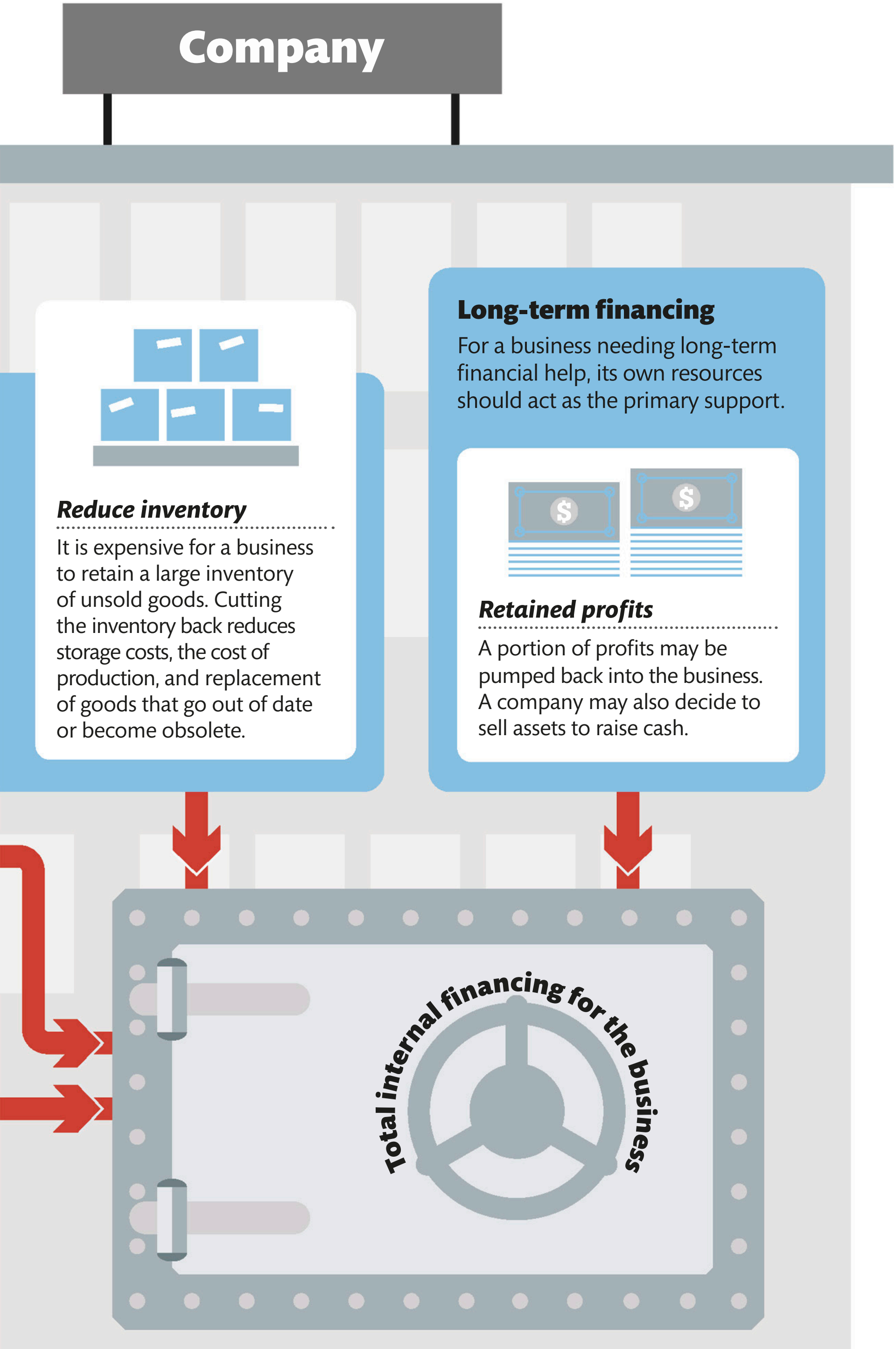


Tighten credit control

Actions include chasing debtors so that invoices are paid on time; ensuring that new customers are creditworthy by conducting strict credit checks; and setting a 30-day payment term.

Delay payment

Large suppliers may offer a discount for early payment, but they may also allow a company longer terms for payment, boosting that company's cash levels in the short term.



USING PROFITS TO FUND EXPANSION

A company seeking to grow may choose to fund the expansion with its profits. This option offers both advantages and disadvantages.

Pros

- The use of profits means that no interest payment has to be made, unlike on money that is borrowed.
- Existing owners and directors are able to retain full control over the business rather than sharing it with new investors.
- The company is able to keep a low debt profile, which will appeal to future investors and lenders.

Cons

- Profits can take time to build up sufficiently to fund expansion.
- Withholding dividends may upset some shareholders, who prefer to receive the profit as dividends.
- There is a lost opportunity to earn funds from investing profit rather than spending it.

56.7

is the average number of days it takes a US company to pay a supplier invoice.

External financing

When business growth or unforeseen expenses cannot be met by using internal sources of financing, such as retained profit, organizations must rely on finding funds from lenders or investors.

How it works

External financial support comes in various forms, including getting bank loans and issuing shares. The available sources of outside financing depend on the amount a company requires and whether the money is needed to resolve a short-term issue, such as cash flow, or for the long-term growth of the business. While short-term financing is easier to secure, finding larger sums for an expansion is more challenging. A company that is either already listed on a stock exchange or is preparing to enlist will be able to raise the capital through the sale of shares. However, an unlisted company may struggle to raise a comparable amount. A company with a large amount of debt will also find it hard to raise funds because lenders or investors will see the business as risky.

NEED TO KNOW

- **Term loan** A bank debt repaid over a set period of time
- **Loan note** A form promising payment to the holder at an agreed future date
- **Eurobond** A bond issued in a currency other than the currency of the country in which it is issued

Raising external financing

Generating funds from external sources can be a challenge, especially when securing investors. However, the funds do not necessarily need to take the form of a loan. There are a number of strategies that can be implemented through working with external parties in order to provide a company with good working capital.

43% of U.S. small businesses applied for new financing in 2019.

Short-term financing

A range of financial agreements that help provide a company with immediate funds can be made with outside parties as a way of raising cash in the short term.

Bank line of credit

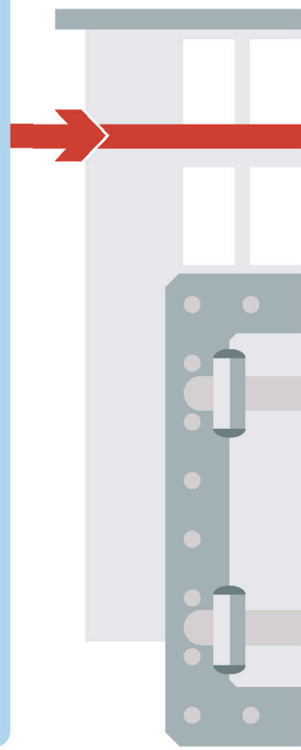
Borrow from business checking account up to an agreed limit, with interest typically at a high rate.

Asset financing

Borrow against assets owned by the business, including inventory, equipment, and property. These can be seized by the lender if firm defaults.

Invoice discounting

Borrow money against sales invoices customers have yet to pay (again, often at a disadvantageous rate).



DEBT FACTORING

Debt factoring is another means by which businesses can raise short-term cash. A company sells unpaid invoices (accounts receivable) to a third party, known as a "factor." The factor advances the company a major portion of the total, holds the rest until the account is paid, and then charges a fee.

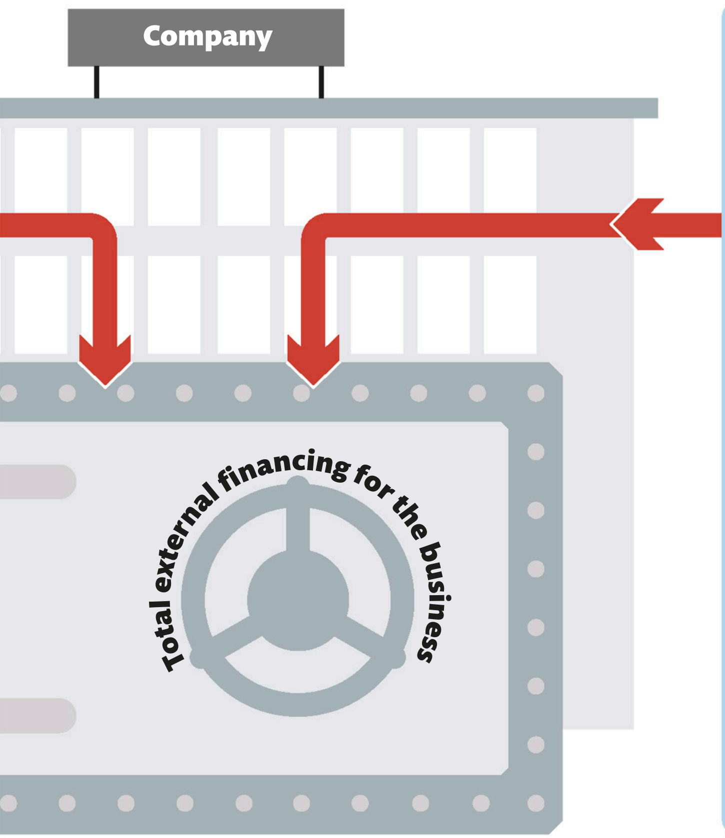
Company negotiates an agreement in which its unpaid receivables (invoices) are sold at a discount to a "factor."

Company sends invoices out to customers and copies them to factor. Customer now owes payment to factor.

Factor pays company an agreed percentage of the invoices (typically 80–90 percent) within a few days of receipt.

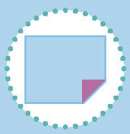
Customer pays factor the invoice amount after 30 days (or more, if terms of payment are longer).

Factor pays remaining invoice amount to company, minus a fee (usually 2–5 percent of the invoice amount).



Long-term financing

Putting effective measures in place to provide ongoing funds is essential for a company's long-term growth.



Shares

Raise capital by issuing shares to finance growth. The company then retains less profit, as it pays dividends to shareholders, who also benefit from any capital gains in the company's value *(see pp.164–165)*.

Borrowing

Secure long-term loans from banks and other financial institutions, usually with better terms than a bank line of credit.

Finance leases

Sell expensive assets, such as computers, to finance companies to release capital and then lease them back.

Rent-to-own agreements

Pay for expensive assets, such as vehicles, in installments. Overall costs may be higher, but capital is not tied up.

Going public

When a company changes from private to public, it offers shares for sale to members of the public. This process is known as going public and enables the company to raise money for growth.

How it works

The process by which an organization goes public (also known as flotation) marks the end of its life as a private company, after which it is no longer owned by a small number of shareholders or company members. A company may choose to go public when it needs capital to finance growth. Going public usually happens over several months; the company makes legal and financial preparations before the final stage, when it releases company shares for sale to selected investors, the general public, or a combination of both. Each share represents a "stake" in the company, and the money that the company receives from the sale of shares becomes capital, or wealth, that it now owns.

WARNING

- **Underestimation** If the initial valuation of shares by the underwriters is too cautious, then the company will fail to realize the true value of its stock.
- **Overestimation** If underwriters overestimate the value of shares newly on the market (new issue), it may flop due to lack of demand.
- **Volatility** Share prices in the first few days of an IPO may fluctuate dramatically due to political or economic events.

Ways to list on a stock exchange

There are three primary ways to take a company public, each of which has different associated costs. The type of public offering that a company chooses will be determined by its size and how much capital it needs to raise.

A company joins a new stock exchange without raising capital but by trading its existing shares. To do this, a significant proportion of the shares must already be in public hands (on other stock exchanges), and no one shareholder can own a majority of shares.

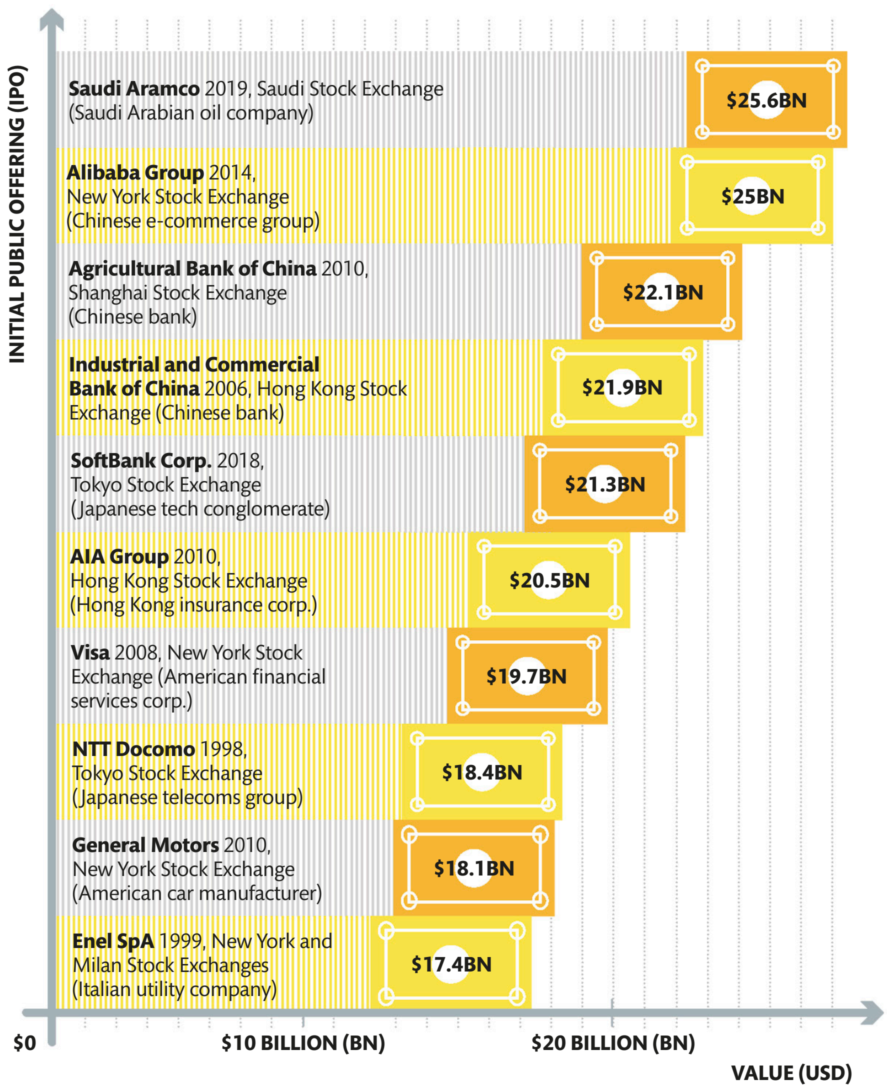
Select groups of institutional investors are invited to buy shares. This involves fewer costs than undertaking a full public share offering (see below), but the amount of capital that can potentially be raised is limited because there are fewer shareholders.

Institutional and private investors are invited to subscribe to or buy from the first round of shares that the company issues. This is the most expensive way to go public, but it allows a company to raise large amounts of capital.

1,415 the number of IPOs that took place around the world in 2020

10 LARGEST IPOS IN HISTORY

When a well-known private company undertakes an IPO, there is fierce competition between investors to buy its shares, and record-breaking activity can ensue. This graph shows the largest IPOs until 2014, based on proceeds from shares sold on the first day they went public.



Stock exchange

A financial market in which company securities (stocks and shares) are bought and sold according to current market rates. *See pp.170–171.*

A closer look at IPOs

An Initial Public Offering (IPO) is the first time that shares in the company are offered for public sale. It is the most common way for a private company to go public if it needs a large injection of capital to fund major expansion. There are other reasons for going public—for example, if a government wants to privatize a state-owned company, such as a national railroad, or if the members of a large family-owned enterprise want to sell their stake.

WORLD'S TOP 10 STOCK EXCHANGES

The largest exchanges manage shares belonging to some of the world's most lucrative businesses and, as a result, substantial sums of money flow through them. The following exchanges are listed in order of the size of market capitalization—in other words, by the total monetary value of shares issued by the companies listed on each exchange.

1. **New York Stock Exchange**
2. **NASDAQ OMX, New York**
3. **Hong Kong Stock Exchange**
4. **Shanghai Stock Exchange**
5. **Japan Exchange Group**
6. **Euronext (Pan-European)**
7. **Shenzhen Stock Exchange**
8. **London Stock Exchange**
9. **Bombay Stock Exchange**
10. **National Stock Exchange**

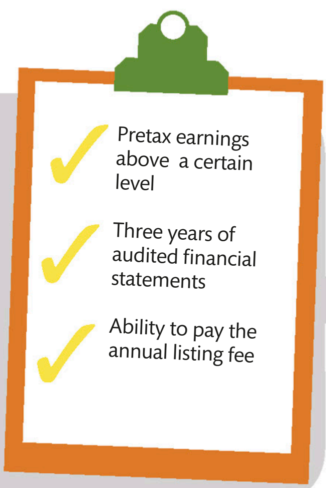
The IPO process

Before a company can issue shares, it has to be listed on a stock exchange where trading (the buying and selling of shares) can take place. The company must then fulfill the criteria necessary to secure investors. This process is lengthy, subject to strict financial regulations, and extremely expensive to undertake. Only once all stages of the process are complete can the share offering be officially declared on a stock exchange.

1

Meet the qualifications

The specific requirements are set by the stock exchange where the company plans to list. Listing conditions vary between exchanges, but typically demand:



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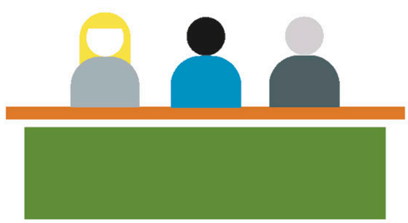
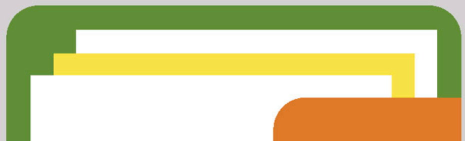


Appoint underwriters

These financial professionals will be responsible for buying and selling the shares to the public.

3



File a prospectus

This document contains information about the offering, the business, its financial history, and proposed plans. Details are still subject to change.

$7.63 trillion

the total market capitalization of companies listed on the Shanghai Stock Exchange*

* as of May 2021

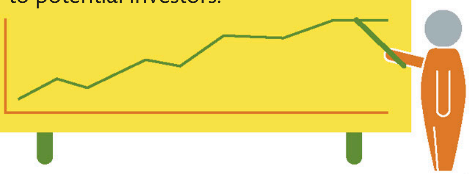
NEED TO KNOW

- **Large cap** Listed company with market capitalization of more than $10 billion
- **Mid cap** Listed company with market capitalization of between $2 billion and $10 billion
- **Small cap** Listed company with market capitalization of between $250 million and $2 billion

4

Promote the share offering

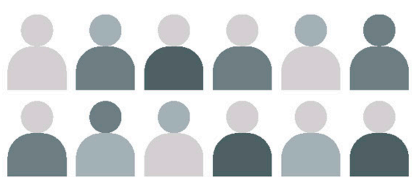
Company representatives as well as the underwriters visit national and international destinations to pitch to potential investors.



6

Sell on the stock market

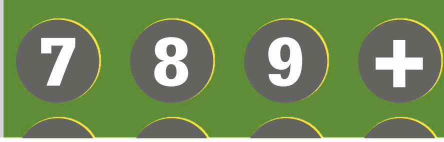
The IPO is officially declared a few days after potential investors receive the final prospectus. The declaration is made on a set day after the exchange has closed, and the shares are available for trading the following day.



5

Set the final offer price

After ascertaining market conditions and the anticipated demand, the company decides the price and the number of shares to issue. It is then ready to launch the offering.



Shares and dividends

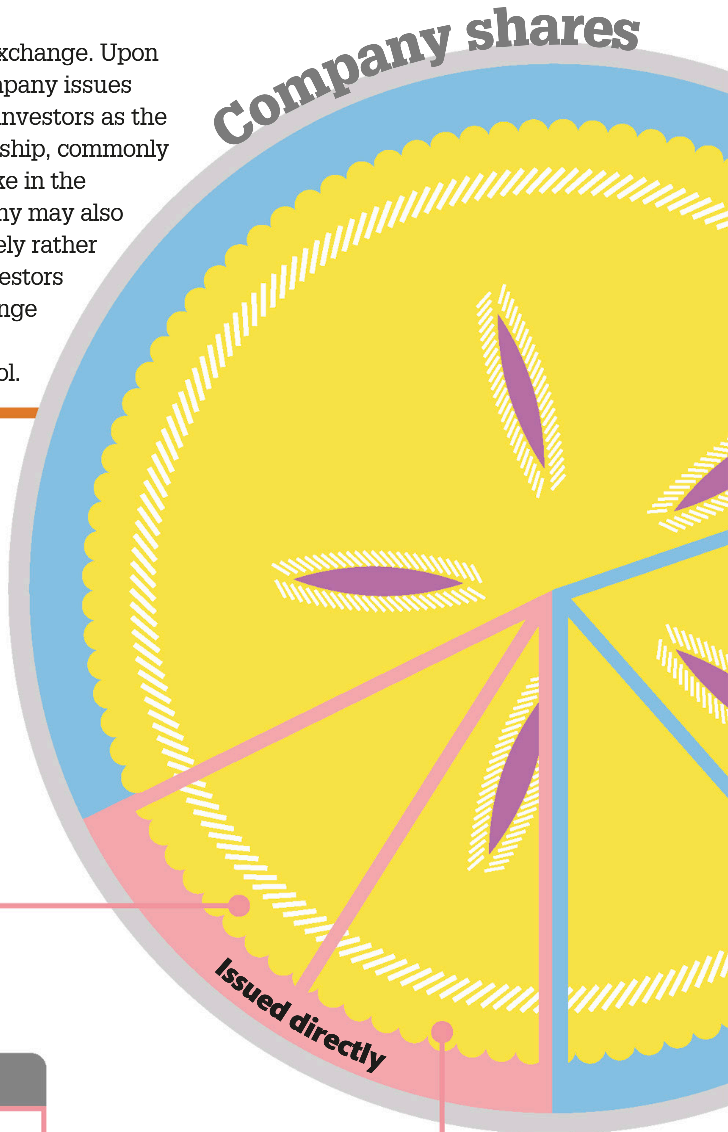
When a company goes public, it sells shares to investors, who become part-owners in return for capital investment. The number and type of shares bought by each investor determine the size of their ownership.

How it works

Before floating on a stock exchange, a company undergoes a valuation process to set the initial price of its shares. This process involves the directors, prospective investors, and an investment bank, which is appointed to assess the company's value. Together, they reach a decision on the most financially viable price for the shares that will be offered on the exchange. Upon going public, a company issues ordinary shares to investors as the basic unit of ownership, commonly referred to as a stake in the business. A company may also issue shares privately rather than publicly to investors via the stock exchange to retain greater management control.

A share of the pie

Ordinary shares, issued by all companies when they go public, are the most common type of shares. There are also other share types, which give the company more flexibility to control rights available to different shareholder groups. Most shares are sold on the stock exchange, but nonvoting and management shares are issued directly to holders. Different types of shares entitle the holder to different rights.



Management shares

Issued (usually given, not sold) to owners and members of company management, who have:

✔ Extra voting rights, so control of company stays in the same hands

Nonvoting shares

Issued to employees, who:

✔ Receive a part of remuneration in the form of dividends

✘ Have no voting rights

✘ Receive no invitation to attend annual general meeting (AGM)

Common stock

Shareholders:

✓Share in the company dividends
✓Share in the company's assets
✓Have the right to attend AGM
✓Have the right to vote on important company matters, such as appointment of directors
✓Receive the company's annual report and financial statements

Preferred stock

Shareholders:

✓Receive fixed dividend, paid ahead of any dividends paid to ordinary shareholders
✓Take priority in receiving a share of any assets left after debts are paid if the company is insolvent
✗ Have fewer, if any, voting rights

Deferred stock

✓Shareholders receive company dividends and share of assets, but only after all other shareholders.

NEED TO KNOW

- **Flipping** Buying and quickly reselling IPOs for a large profit
- **Redeemable shares** Shares that may be later bought back by the issuing company for a cash sum

$67,564

what $100 invested in Apple's 1980 IPO was worth 40 years later

RAISING MORE SHARE CAPITAL

After the initial sale of shares, when a company goes from private to public, the business can raise additional funds by issuing more shares. There are three main ways to do this:

- **Rights issue** entitles existing shareholders to buy additional shares from the company within a set time frame, before they are offered to other buyers.
- **Public issue** is a process by which the company issues a new allotment of shares to sell to the public on the stock market.
- **Private placement** is a practice by which the company sells its shares (or other securities) directly to private investors, usually large institutions, bypassing the stock exchange all together.

Establishing share value

The forces of supply and demand set the price of shares. Companies issue only a limited number of shares to the public, which can then be bought and sold on the stock exchange. Demand for those shares is determined by whether investors think the company has good future economic prospects. If investors believe that the company is primed for substantial growth, they will want to buy shares in it, which consequently drives up the share price.

25% the drop in share value over four days during the Wall Street Crash of 1929

SPLITTING SHARES

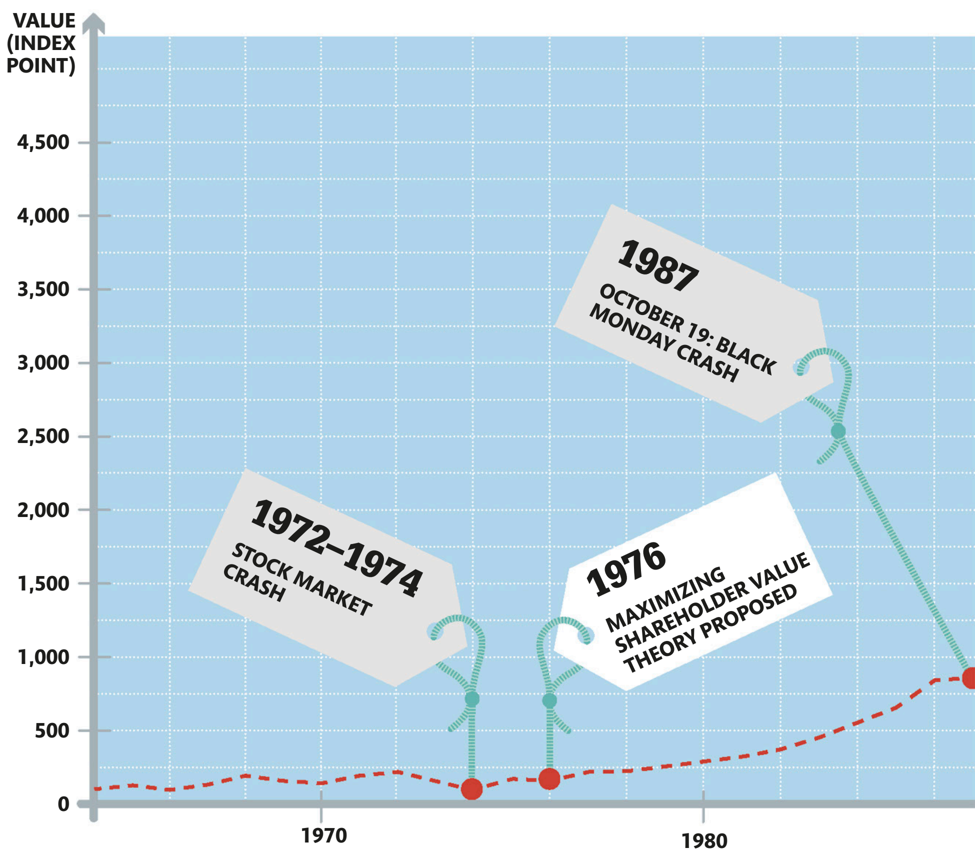
A company occasionally carries out a "share split" to its existing shares. This increases the total number of shares, although the combined value of shares stays the same. A share split allows a company to lower the price of its shares to bring them in line with the price of competitor shares. The share split is usually a two-for-one or three-for-one increase, whereby the shareholder sees the number of their shares double or triple.

Rising value of shares

Financial market observers believe that the emphasis on optimizing the value of shares for shareholders began in 1976, when the idea of maximizing profit for shareholders became a priority. Since then, the market has experienced a general upward trend with occasional deep dips. The graph tracks the average value of all shares on London's FTSE from 1964 to 2021.

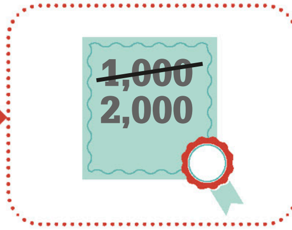
NEED TO KNOW

- **Bear market** Market that has seen decline of 20 percent over a period of 2 months or more
- **Bull market** Market where share prices are rising and investor confidence is high
- **Market correction** Short-term decline in share prices to adjust for an overvaluation



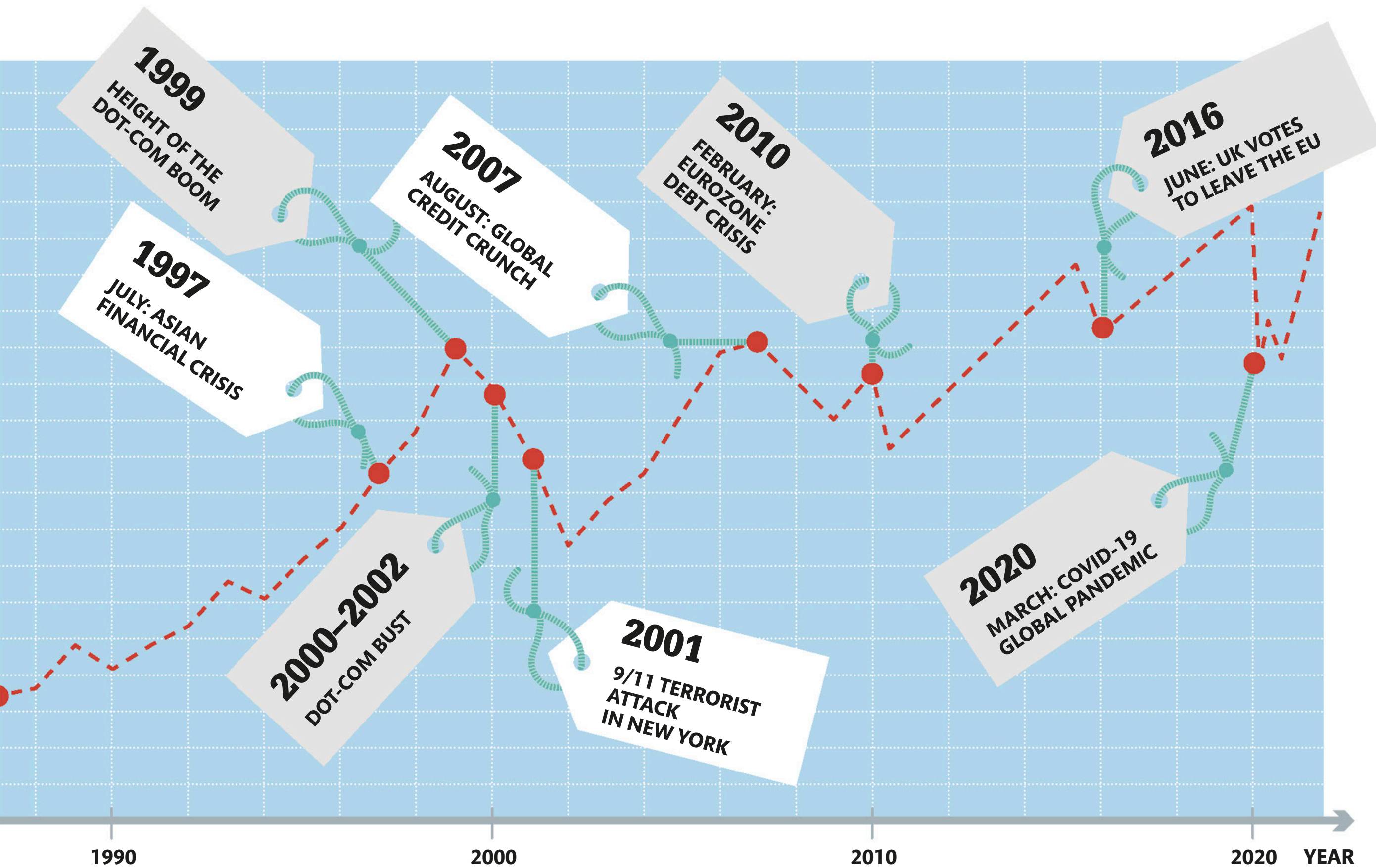
SHARE PRICE TOO HIGH
A company listed on the stock exchange has seen its share price increase so that its shares now cost more than its competitors'. The high price puts off investors.

SHARES SPLIT
The company decides on a share split. It halves the price of each existing $3 share, so each share is now worth $1.50.



SHARE CERTIFICATES ISSUED
It issues new share certificates to holders, doubling shares held: a shareholder with 1,000 shares at $3 each now has 2,000 at $1.50 each. Total worth is still $3,000.

SHARE VALUE ALIGNED
The value of shares is now similar to that of competitors. The price encourages new investors to make a purchase.



What is a dividend?

Shareholders in a company are usually entitled to a payment of cash from its profits. The company pays a dividend sum on every share it has issued, but it is up to the company's board to decide how much profit to reinvest and pay out. Investors may look at a company's rate of dividend payout, along with its capital growth, to gauge its financial health and decide whether to invest in it. Investors who rely on shares for income are likely to invest in companies that reliably pay out dividends. In a good economic climate, they win twice—the dividend provides income, and the capital value of the shareholding increases. However, there is always a risk that the value of shares will go down, and companies only pay dividends if they have made a profit.

Paying dividends is a good way for a company to attract investors. It is essentially a reward for putting money into a company so that it can fund its existing output and develop and expand the business.

NEED TO KNOW

- **Dividend yield ratio** Measure of how much a company pays in dividends relative to the price of each share
- **Dividend per share** Sum paid on each share after retained profits have been calculated
- **Dividend payout ratio** Percentage of a company's net income that is paid in the form of dividends

How it works

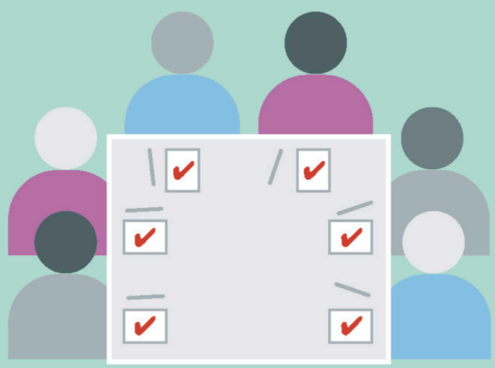
Shareholders usually receive a dividend if the company in which they hold shares has retained enough profit in that financial year to make the payment. The decision to make a payment is made by the board of directors. The dividend might be paid every quarter (four times a year) or in two parts—an interim dividend may be made partway through the year, with the final dividend paid just after the end of the financial year.

Announcing retained profits

At the end of the financial year, the company announces its retained profits: the sum it intends to keep for reinvesting or paying off debts rather than pay as dividends.

Making the decision for dividends

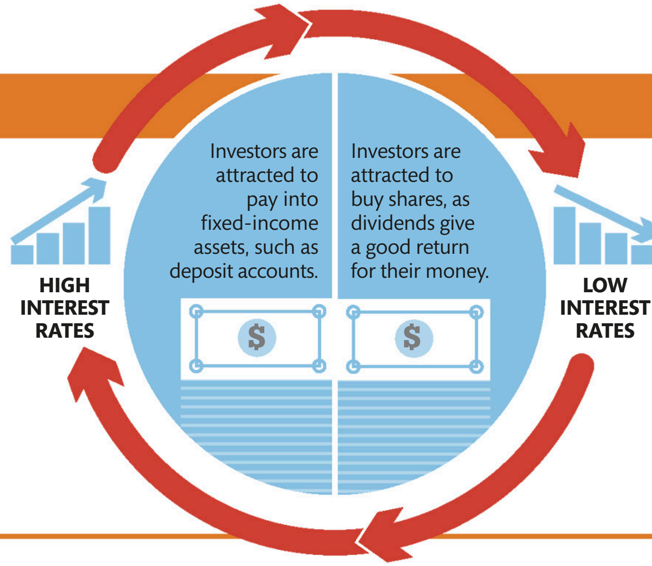
The board of directors makes a decision on whether there is enough to warrant a dividend payment and, if so, how much. It records details of each payment in dividend vouchers.

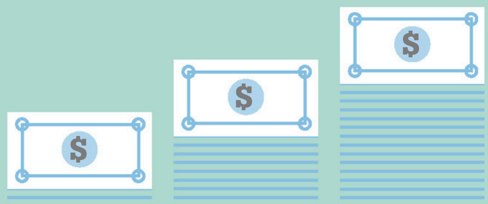


INTEREST RATES AND DIVIDENDS

When interest rates are low, shares with high dividend payouts become extremely attractive to investors because they provide a better return than investments that yield an interest payment. This economic climate encourages companies to pay top-rate dividends and therefore attract as many investors as possible, which in turn increases the share value.

Conversely, when interest rates are rising, investors may prefer to put their money into fixed-income assets, which will pay high rates as a result of the hike without the risk attached to buying shares.

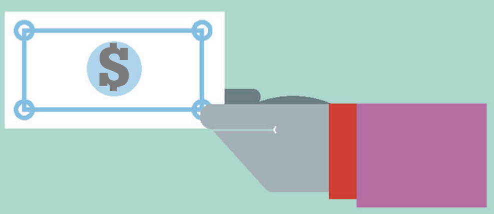




Keeping funds for growth

The company keeps some of its profit to put back into the business. It needs to strike a balance between pleasing investors and expanding its operation.

1602 the year the Dutch East India Company became the first business to issue stocks and bonds

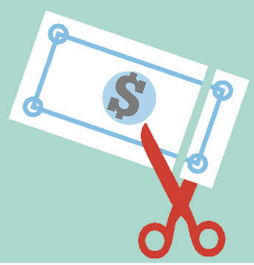


Making the payment

Most dividends are cash dividends. Sometimes, companies distribute stock dividends, issuing more shares instead of cash to shareholders.

Paying taxes

Shareholders must declare dividends on their tax return and pay taxes on them.



The capital market

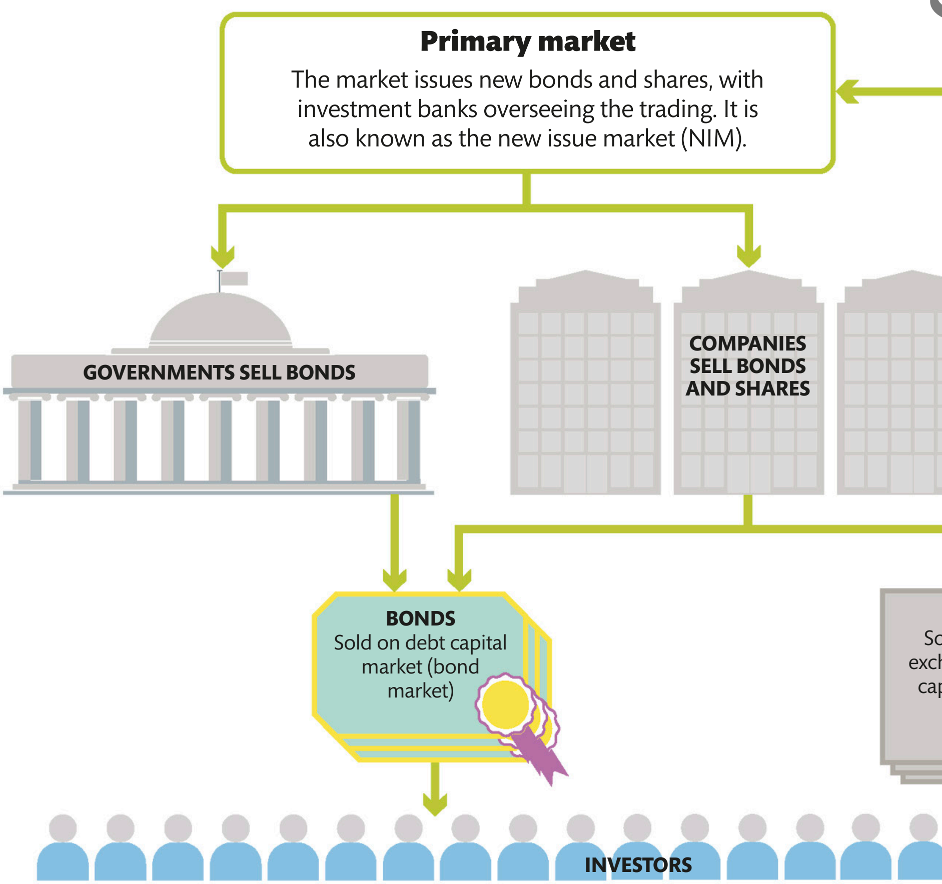
The capital market is a global marketplace for trading long-term securities—bonds with a maturity of at least a year and shares. It is where governments and businesses raise funds and investors make money.

How it works

There are two types of products sold on the capital market: shares (equity) and bonds (debt investments). Shares and bonds are sold first on the primary market, where they are originally issued, and later traded on the secondary market. The capital market is crucial to a functioning economy because it channels funds to users of capital, such as businesses and government, and capital is what enables goods and services to be produced. The original issuers of the shares and bonds do not gain from trading activity in the secondary market, which is purely for investors. However, share value and bond trading levels reflect confidence in a company or institution, reinforcing its financial position.

The structure

The capital market encompasses the debt capital market, where bonds are sold, and the stock exchange, where shares are sold. Both have a primary and a secondary market.

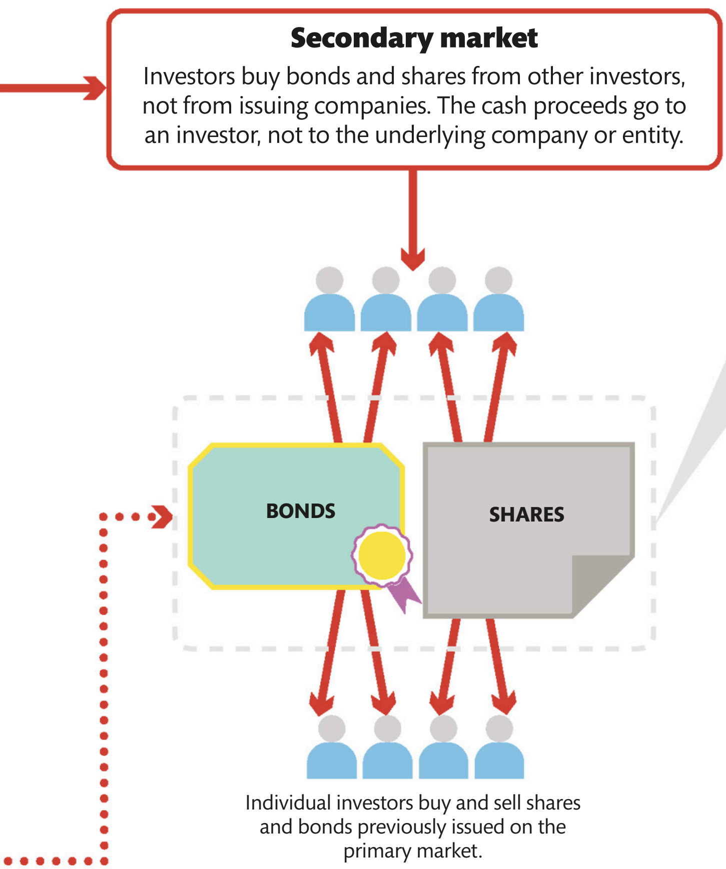


WHAT IS A BOND?

A bond is a debt security that a company issues to investors. By buying bonds, an investor is effectively loaning money to the issuers, who in return agree to pay interest to the investor. A bond has a set term of maturity (a limited number of years of validity), and until that time, the interest is paid to the investor annually. When the bond matures, the issuer repays the original sum of the loan to the investor. Companies or governments issue bonds to raise money that can then be put back into the business or used to fund government.

US$119 trillion

the estimated value of global bond markets



Individual investors buy and sell shares and bonds previously issued on the primary market.

Bonds or shares: pros and cons

Bonds (debt investments)

- ✓ Sellers are contractually obliged to pay interest.
- ✓ Bonds are less risky: debt capital markets are less volatile than stock exchanges. If the issuing company has trouble, bondholders are paid before other expenses and before compensation to shareholders.
- ✗ Buyers of bonds have no stake in the company.
- ✗ Buyers cannot access the principal sum until bonds mature.

Shares (equity)

- ✓ Buyers of shares gain a stake in the company.
- ✓ Sellers of shares have to pay dividends, although these can be reduced or suspended if the company believes it is necessary.
- ✗ Shares are more risky: changes in company profits and in the economy as a whole can cause share prices to rise and fall. If the company fails, the shares become worthless.

How do bonds work?

Bondholders effectively buy a slice of a larger loan with each bond, for which they receive interest, along with the original sum on maturity. Issuing, buying, and selling bonds take place in the debt capital market. The marketplace has several functions: it offers bonds and other types of loans to investors; it operates as a fixed-income market, because the issuer is required to pay regular interest; and it enables companies and governments to raise long-term funds. Overall, the debt capital market is much larger than the stock exchange (equity capital market), where shares are bought and sold. It attracts investors because bonds provide more protection from risk than shares. There are various types of bonds, some safer than others—the risk lies in whether the issuer will be able to pay the interest and repay the principal sum on maturity. A secured bond is backed by an asset, such as property; an unsecured bond is not and so carries more risk.

Both bonds and shares may be referred to as securities. The term describes the share or bond itself and the certificate of ownership or creditorship that gives the holder the right to receive a dividend, in the case of shares, or interest payments, in the case of bonds.

NEED TO KNOW

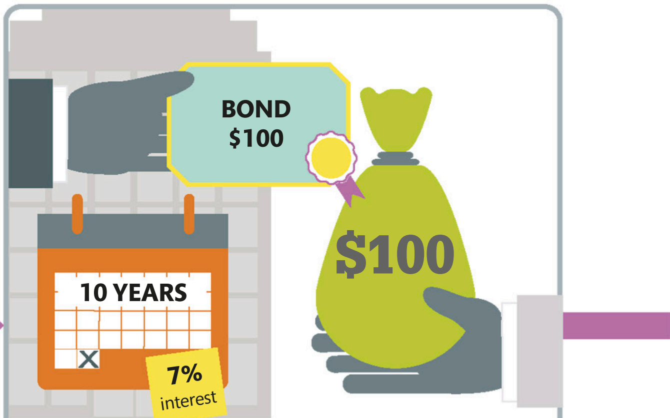
- **Debt instrument** Official term for bond or other long-term debt
- **Convertible bond** Bond that can be converted into shares of the issuing company or cash
- **Warrant** Security that allows the holder to buy stock in a company at a fixed price
- **Callable bond** Bond that gives the issuer the right to redeem it before maturity
- **Noncallable bond** Bond that has no maturity and cannot be redeemed or sold back to the issuer but continues to provide interest

Investing in the debt capital market

A company wants to raise $100 million to finance growth but does not wish to issue further shares. Instead, it raises the money by issuing bonds on the debt capital market.

Company issues bonds

The company issues 1 million bonds at $100 each. Each bond effectively acts as a loan between the investor and the company.



Investors buy bonds

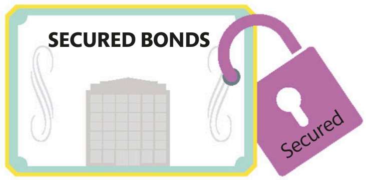
Each bond has a set maturity date of 10 years and a 7 percent interest rate, with a face value of $100. During the 10 years, the company can use the money as capital.

TYPES OF BONDS

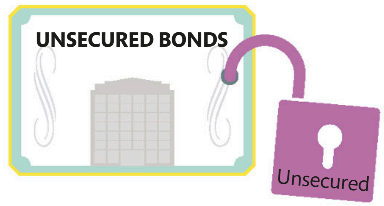
Government bonds

Government bonds are the safest type of bond because governments in developed capitalist economies are unlikely to default on interest payments on the loan or on the principal sum.

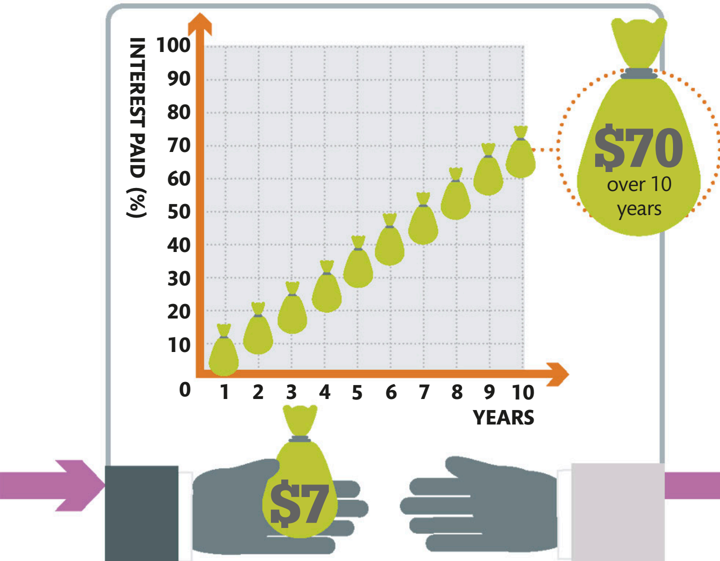
Corporate bonds



Secured bonds are secured by the assets of a company, making them a less risky investment than shares. Examples include equipment, trust certificates, and mortgage bonds.



Unsecured bonds are not backed by pledged collateral and are a riskier investment—if the company fails, investors are paid only after secured bonds have been paid out. Because they are more risky, investors expect a higher return (interest) on their investment.



Investors receive annual interest

Each year, the company pays an investor $7 (7 percent of $100) for each bond bought, in return for using the principal sum as capital to fund its business. After 10 years, the investor has received a total of $70 interest per bond.

Mature bond is repaid

Once the bond reaches its date of maturity, in this case 10 years, the original sum of money, $100, is repaid to the investor. So, the investor receives a total of $170, including interest, over the full term, in return for the original $100 investment.

Gearing ratio and financial risk

Capital gearing is the balance between the capital a company owns and its funding by short- or long-term loans. Investors and lenders use it to assess risk.

How it works

Most businesses operate on some form of capital gearing (also called financial leverage). They partly fund their operations by borrowing money, via loans and bonds, on the condition that they make regular repayments of a fixed amount to the lender. If the level of gearing is high (in other words, the business has taken on large debt), some investors will be concerned about its ability to repay and see this as an insolvency risk. However, if the amount of operating profit is more than enough to repay interest, high gearing can provide better returns to shareholders. The optimum level of gearing for a company also depends on how risky its business sector is, how heavily geared its competitors are, and its current life cycle stage.

Equity finance (shares)

Pros

- Does not have to be repaid
- Shareholders absorb loss.
- Good for start-ups, which may take a while to become profitable
- Angel investors share expertise.
- Low gearing is seen as a measure of financial strength.
- Low risk attracts more investors and boosts credit rating.

Cons

- Shared ownership, so company has limited control of decisions
- Shared profit in return for investors risking their funds
- Legal obligation to act in the interests of shareholders
- Heavy administrative load
- Complex to set up

Low gearing

Company has less debt

Company has more equity

Low proportion of debt to equity, also described as a low degree of financial leverage. Equity comes from:

- Reserves (retained profits)
- Share capital

Gearing ratio calculation

Analysts and potential investors assess the financial risk of a company with this calculation, presented as a percentage.

$$\frac{\text{LONG-TERM DEBT}}{\left(\begin{array}{c}\text{SHARE CAPITAL +}\\ \text{RESERVES +}\\ \text{LONG-TERM DEBT}\end{array}\right)} \times 100$$

Low gearing

A software company is going public. Its ratio of 21.2 percent tells investors that it has relatively low gearing and is well positioned to weather economic downturns.

$$\frac{\text{\$1.2 MILLION}}{\left(\begin{array}{c}\text{\$2 MILLION + \$2.455 MILLION +}\\ \text{\$1.2 MILLION}\end{array}\right)} \times 100 = 21.2\%$$

High gearing

Company has more debt

High proportion of debt to equity, also described as a high degree of financial leverage. Typical examples of debt are:

- Loans
- Bonds

Company has less equity

Debt finance (loans)

Pros

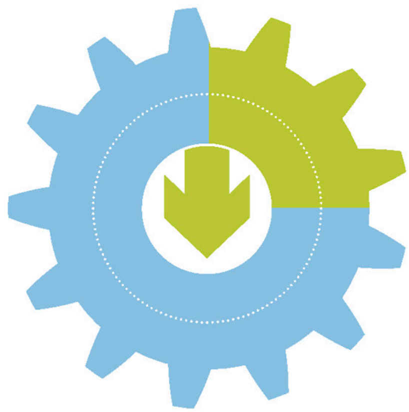
- If the company makes a profit, it can reap a larger proportion.
- Paying interest is tax deductible.
- Does not dilute ownership
- Company retains control of decisions.
- Repayment is a known amount that can be planned for.
- Quicker and simpler to set up
- Small business loans at favorable rates may be available to start-ups.

Cons

- Loan must be repaid.
- Interest must be paid, even if operating profit shrinks.
- Debt may be secured on fixed assets of company.
- Unpaid lender can seize assets and force bankruptcy.
- Lenders are first to be paid in the event of insolvency.
- High gearing is considered a measure of financial weakness.
- High risk may put off investors and adversely affect credit rating.

NEED TO KNOW

- **Interest cover ratio** An alternative method of calculating gearing—operating profit divided by interest payable
- **Overleveraged** A situation in which a business has too much debt to meet interest payments on loans
- **Deleverage** Immediate payment of any existing debt in order to reduce gearing



25% the ratio at or below which a company is traditionally said to have low gearing

High gearing

A water utility is the only water provider in the area, with several million customers. The ratio of 64 percent is acceptable for a utility company with a regional monopoly and a good reputation.

$$\left(\frac{\$360\text{ MILLION}}{\$82\text{ MILLION} + \$120\text{ MILLION} + \$360\text{ MILLION}}\right) \times 100 = 64\%$$

HOW SALES AND MARKETING WORKS

Marketing mix ❯ Marketing approaches
Outbound marketing ❯ Inbound marketing
Business development ❯ Information management

Marketing mix

The successful marketing of a product or service depends on the consideration of four key elements—the product itself, its price, how it is promoted, and where it is sold. This combination is called the marketing mix, and it is used as a tool for planning product launches and campaigns. Before focusing on the marketing mix, marketers need to define the target market for their product by determining which groups of customers are most likely to purchase it.

The 4Ps and 4Cs of the marketing mix

First proposed in 1960, the classic marketing mix tool contains the 4Ps: product, price, promotion, and place. In the 1990s, these were recast as the 4Cs, which emphasized the customer-oriented dimension of the tool.

The 7Ps of the marketing mix

Some marketers use a more detailed model of the marketing mix, which has three additional elements.

- **Product** *See pp.180–183.*
- **Price** *See pp.186–187.*
- **Place** *See pp.188–189.*
- **Promotion** *See pp.190–191.*
- **People** Does the business employ the right people to deliver optimum service to customers?
- **Process** Are effective systems in place for handling orders and dealing with customer questions and complaints?
- **Physical environment** Does the design and layout of the business premises appeal to customers?

Commodity

- **Has the product been specifically engineered** and designed to meet and exceed customer expectations?

Product

- **Is the product the right design, size, and color** to appeal to customers?
- **What are its unique features?** How does it compare with competitors?

Communication

- **What is the most meaningful way** to get marketing messages to customers and provide them with useful information?

Promotion

- **What combination** of marketing and media channels will be most effective?
- **When is the best time** to run promotions?

"Product, promotion, and place create value. But price harvests value."

DEFINING THE MARKET

In order to establish a marketing strategy for the product they are introducing to the marketplace, businesses have to define the customers they aim to sell to by researching and segmenting the market.

Market research

See pp.192–193.

- Identifies gaps in the market for the launch of new products
- Measures customer reactions to new offers and campaign messages

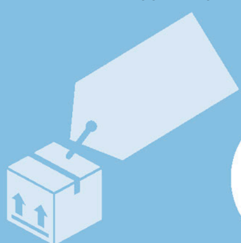
Market segmentation

See pp.194–195.

- Breaks down the market into smaller customer groups with similar needs
- Allows more focused campaigns with a greater chance of success

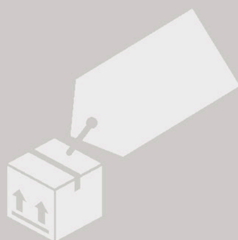
Price

- **What is the value of the product** to prospective customers?
- **What is the usual price point** for this type of product?



Cost

- **How much will the product cost the customer**, and will it be perceived as a good buy?



Place

- **Where should the product be sold**—stores, online, or catalogs?
- **Where do competitors sell**, and is there a way to stand out in the same place?

Convenience

- **How easy is it for busy customers to find** and buy the product?

The 7Cs of the marketing mix

This model offers a customer-focused variation of the 7Ps, adding three more elements to the 4Cs.

- **Commodity**
- **Cost**
- **Convenience (or Channel)**
- **Communication**
- **Corporation** How do company structure, stakeholders, and other competitors affect marketing?
- **Consumer** What are the customer's needs and wants? Is the product safe? What product information is available?
- **Circumstances** Can the business deal with external factors, such as laws, weather, economy, culture?

Product

The goods and services a company sells are its product. A product can be defined in terms of features, design, size, packaging, service type, return policies, and warranties, all intended to meet the customer's needs.

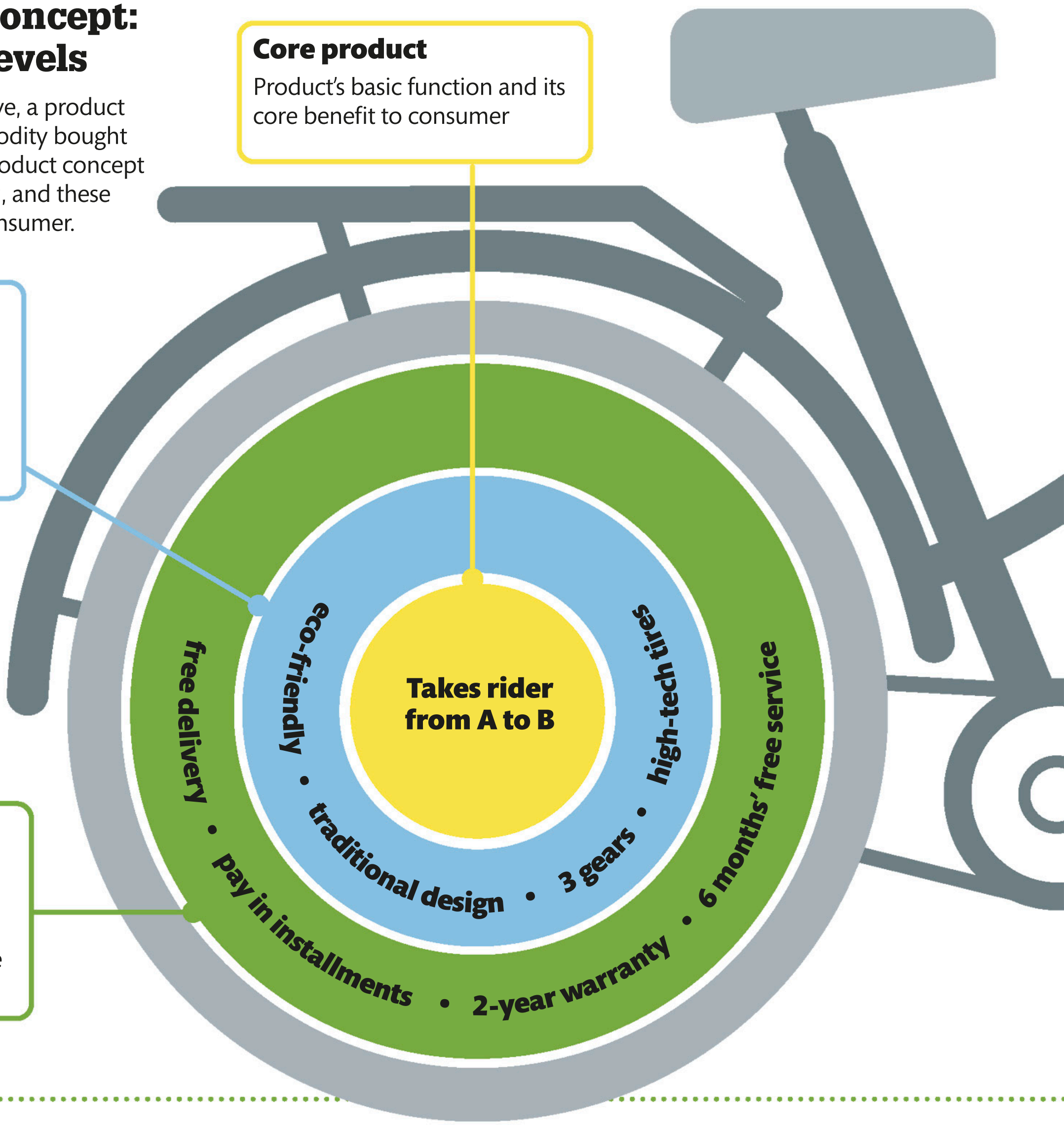
How it works

Consumers can be said to buy benefits rather than products. For the marketer, the product itself is that benefit to the consumer, as packaged and presented.

Marketers identify the goods and services they sell in three or five product levels, with the benefit at the core. The marketer's job is to translate and communicate each product level as an offer to the consumer.

Total product concept: three product levels

From a marketer's perspective, a product is more than the end commodity bought by a customer. It is a total product concept with several layers of benefit, and these must be conveyed to the consumer.



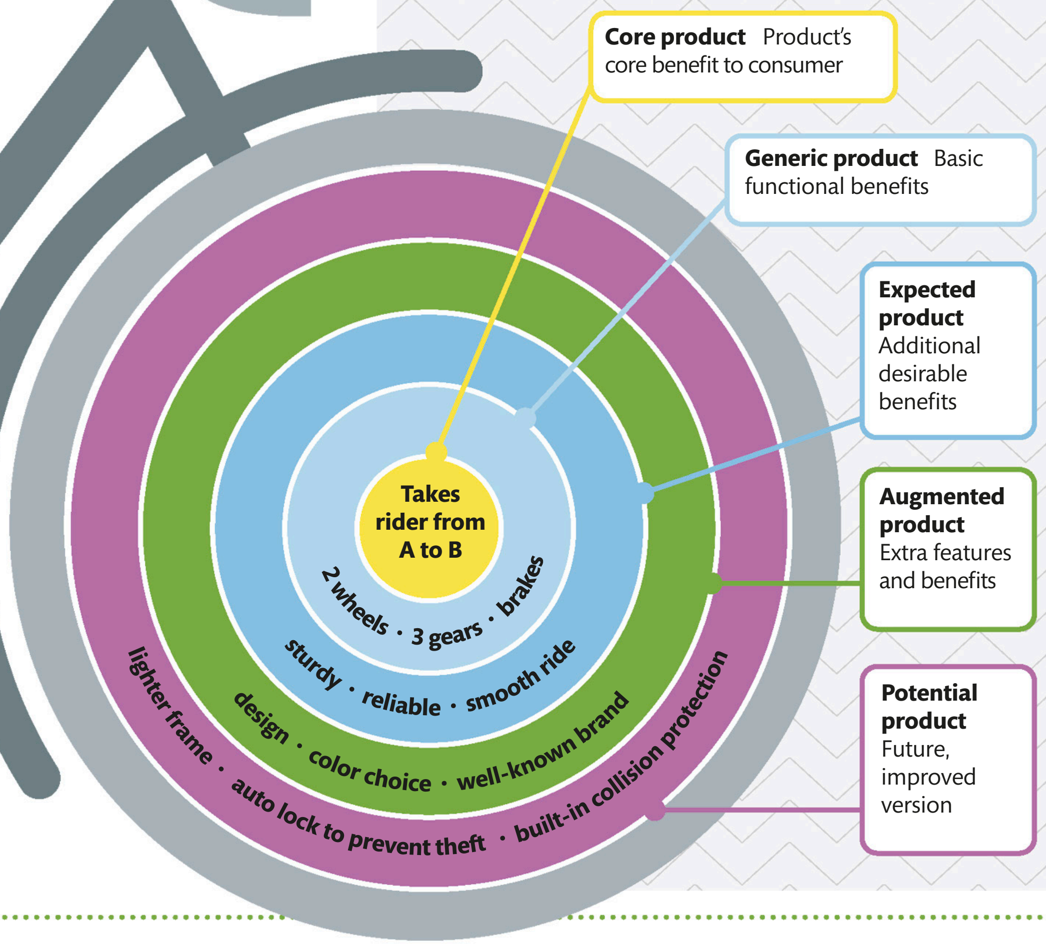
40% of new products are still on the shelves three years later.

NEED TO KNOW

- **Personal branding** Promoting oneself as a product with a distinct brand personality
- **Fast-moving consumer goods (FMCGs)** Sold quickly and at relatively low unit cost, such as food and household products

Variation: five product levels

This variation on the total product concept is more detailed. It introduces two more levels by breaking down the actual product level into a generic and an expected product and also includes an extra level of benefit—the potential product.



Product positioning

A vital step in the process of deciding how to market a product is defining how it is distinct from the competition—what is unique about it and what are the qualities that make it better than rivals.

How it works

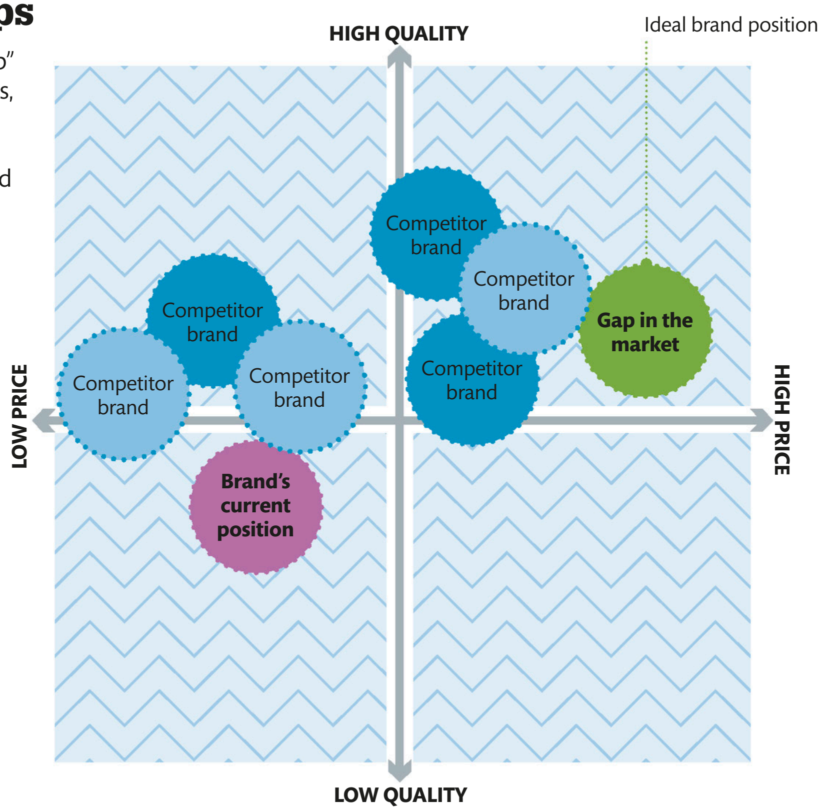
Before a company launches a product, the marketing department has to decide how to position it in the marketplace compared to competitors' products. To determine the positioning of a product, marketers must define the most important features and values of the product or brand and clarify how it is different from similar types of products offered by competitors. They also need to identify the criteria that customers are most likely to use when choosing a particular product or brand. With this information, the marketers can then create a product positioning matrix or map.

Product positioning maps

Marketers commonly create a perceptual "map" using a product's two most important attributes, presented as variables on an *x* and *y* axis, to determine where to position it. Attributes may include price, quality, status, features, safety, and reliability. Once the map is labeled, existing products are placed on it to reveal the best position or gap for the proposed launch.

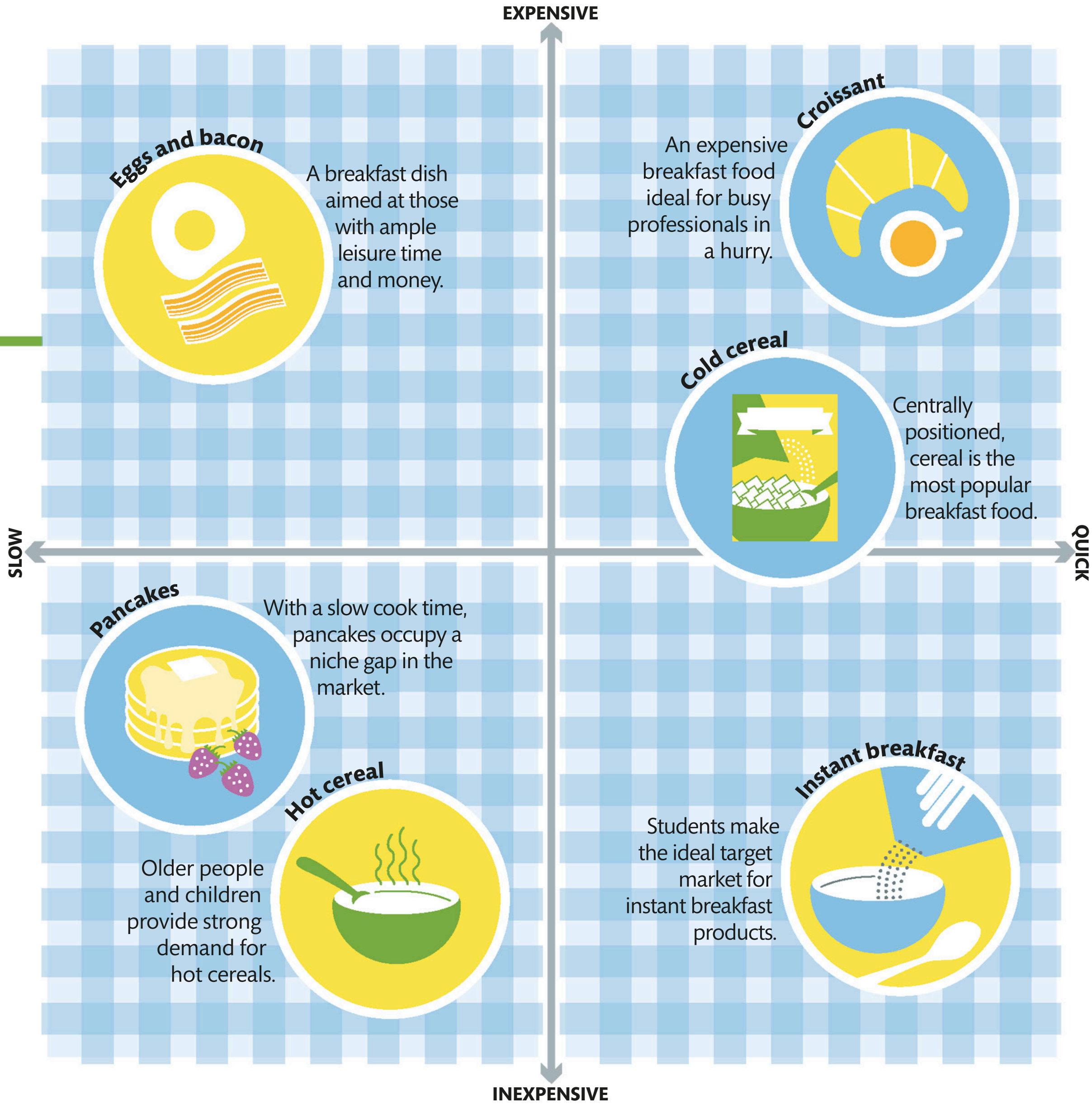
FOUR POSITIONING STRATEGIES

- **Value positioning** A product plotted on the map so that it has an attractive price while delivering good functional qualities.
- **Quality positioning** A product that is located on the map on the basis of its perceived quality or superiority.
- **Demographic positioning** A product mapped according to its appeal to a specific population segment, such as consumers with a particular occupation.
- **Competitive positioning** A product that is very similar to those of competitors, relying on correct pricing to find a viable position in the marketplace.



Product positioning template

The map shows how marketers position competing products in the marketplace according to the price/quality variables (the most commonly used) to identify a gap for the new product.



Breakfast positioning map
The positioning of the various breakfast foods has been determined by the speed at which the food is prepared, measured from slowest to fastest, and the price of each food type, from the least expensive to the most expensive.

"Positioning is not what you do to a product. [It] is what you do to the mind of the prospect."

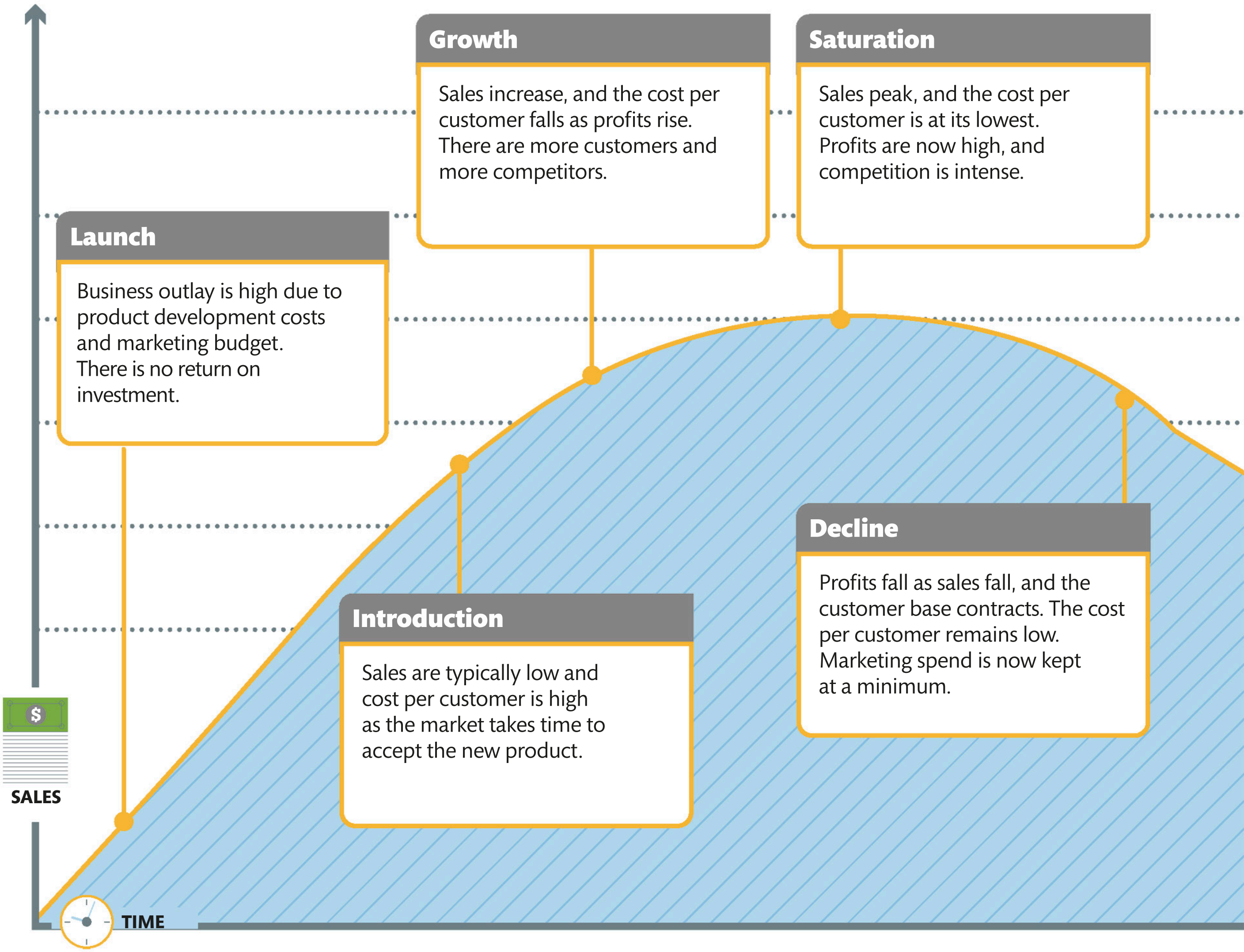
Al Ries and Jack Trout, *marketing strategists*

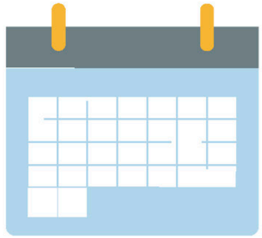
Product life cycle

Every successful product launched on the market experiences growth followed by decline. To maximize profitability, business managers must recognize and manage each stage of the product's life-span.

How it works

There are typically six identifiable stages in a product life cycle, with the product's rate of growth measured by time and revenue. Most businesses have more than one product on the market at any time, and strategic manipulation of the portfolio of products at their different stages in the cycle is crucial to maintaining business growth. The life of older products may be prolonged by extension strategies, but if they are no longer grabbing new market share, the business must consider launching new products in order to continue generating revenue.



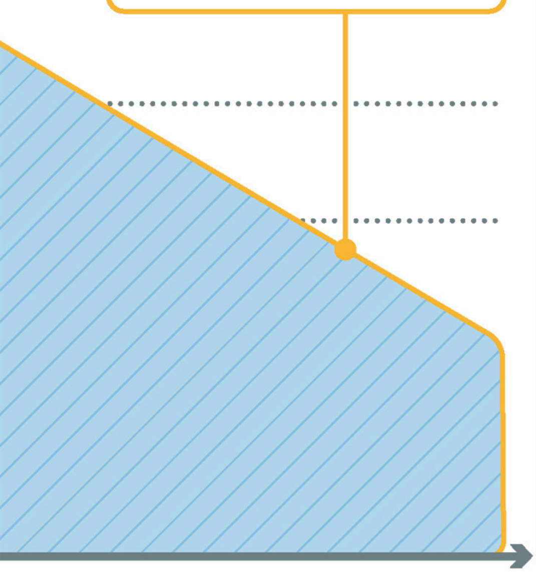


6 months

the length of time a product can be labeled as "new"

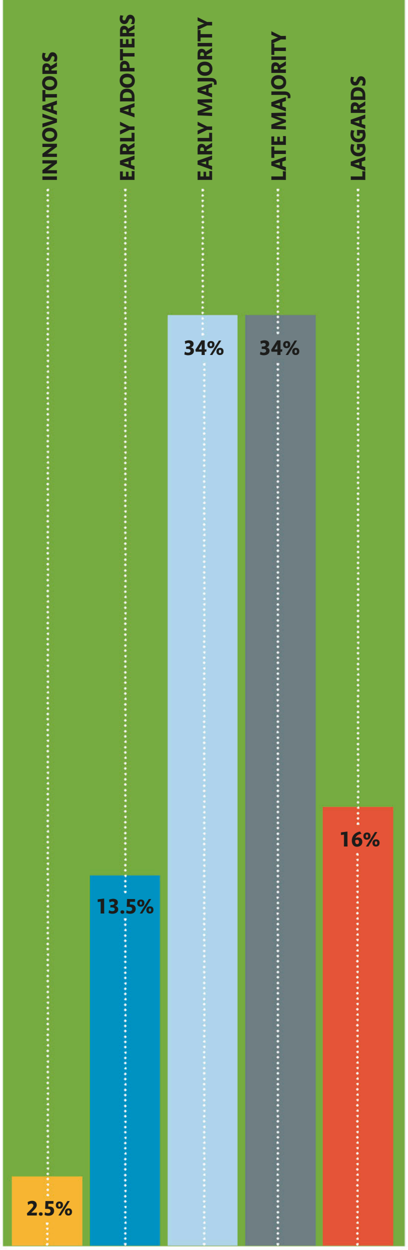
Withdrawal

The product is phased out as sales stall or continue to fall. The business introduces a replacement product before the old one is withdrawn.



Diffusion of innovation (consumer uptake) %

Marketers identify five distinct customer types according to how quickly they pick up on a new product.



NEED TO KNOW

- **Extension strategy** Revival of a product by rebranding, repackaging, or repricing it or finding new markets
- **Portfolio analysis** Each of a company's products measured by growth rate and market share to determine marketing spend
- **Product life cycle management (PLM)** Management of a product from inception to withdrawal

PORTFOLIO ANALYSIS

Rising stars

Products with a high market share in a high-growth market; they require a big marketing spend to keep them growing.

Cash cows

Products with a high market share in a low-growth market; they generate money to support rising stars.

Problem children

Products with a low market share in a high-growth market; they need a big marketing spend.

Dogs

Products with low market share and low growth; they may stay in portfolio to keep customers happy.

Price

Price is a crucial variable of the marketing mix: it generates revenue, while product, promotion, and place yield costs. Pricing may also be the marketer's most potent tool because even minor tweaks affect returns.

How it works

To set the price of a product, marketers adopt a pricing strategy based not only on the actual cost of production but also on the perceived attractiveness of the product to consumers. If consumers think a product has a high value, they will be prepared to pay more for it, but if they believe the value of the product is low, they will look for the cheapest price among competing products.

A business must also take into account the price charged by rival organizations, particularly in competitive markets. Setting a price above that charged by competitors can only work if the product is superior to others.

NEED TO KNOW

- **Price, value, and cost**
  Price refers to the amount a product sells for; value refers to it's perceived value to the buyer; cost is the amount that has been spent to manufacture the product

Pricing strategies

A number of different strategies can be used to determine the price of a product. Cost-plus pricing is a retail markup used by many companies to ensure a profit is made. For example, adding a markup of 50 percent to a product that costs $2 to make means that every unit will sell for $3, generating a $1 profit.

Pricing matrix: price vs. quality

A product's quality affects its price tag—the higher the quality, the more money consumers will pay for it—but marketers use strategies that play on the interaction between price and perceived quality.

"Price is what you pay. Value is what you get."

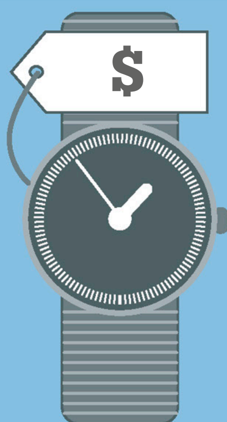
Warren Buffett, *investor*

Low quality

Low price

Economy

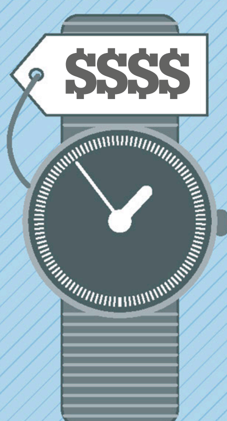
- **High prevalence** Manufacture a product that is very similar to others in the same category.
- **Low price** Undercut competitors' pricing and gain a larger share of the market.
- **Minimal marketing** Keep the marketing and branding spend as low as possible.



High price

Skimming

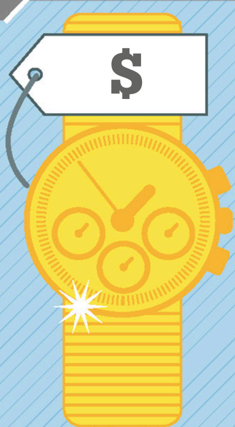
- **High launch price** Charge more than usual in the short term while a product is seen as unique.
- **Correct timing** Set a higher price when the business has a temporary advantage in the marketplace, before competing products appear.
- **Price adjustment** Reduce the price once competitors enter the market or to draw more customers.



PRICING MARKUP COMPARISON

Different industries adopt different approaches to markups. A markup of two to five times the cost is typically applied to drinks served in bars and restaurants. The highest markup is usually applied to the second-cheapest bottle of wine on the wine list, as people tend to avoid the cheapest item.

High quality



Market penetration

- **Low price** Charge the lowest price possible in order to lure customers away from competitors.
- **Price adjustment** Increase the price to a normal level once the product has a loyal following.
- **Pricing flexibility** Reassess pricing; initial high-volume sales lower cost of production, allowing price tweaks.

Premium

- **High price** Charge as much as the market will pay for an item.
- **Unique value** Apply premium prices to products that have no comparable substitute, such as famous brand-name goods.
- **High production cost** Charge a premium price because a product is customized and offers no savings through volume manufacturing.

Other pricing strategies

Psychological pricing

Manipulate a customer's emotions, appealing to their thrifty side or desire for prestige.

Bundle pricing

Offer several products for an overall price, providing better value than buying separately.

Geographic pricing

Charge different prices for the same product in different locations.

Nonpricing strategies

Avoid adjusting the price to attract sales, promoting superiority of product instead.

Place

Knowing where customers shop, where a product is sold, and how efficiently goods can be delivered to the consumer—called "place" in marketing terms—is essential to sales success.

How it works

Whether a company sells goods or services, customers must be able to find and buy those products as easily as possible. Businesses have to decide on the best sales outlet and sales channel to get their products to customers in a way that benefits both parties.

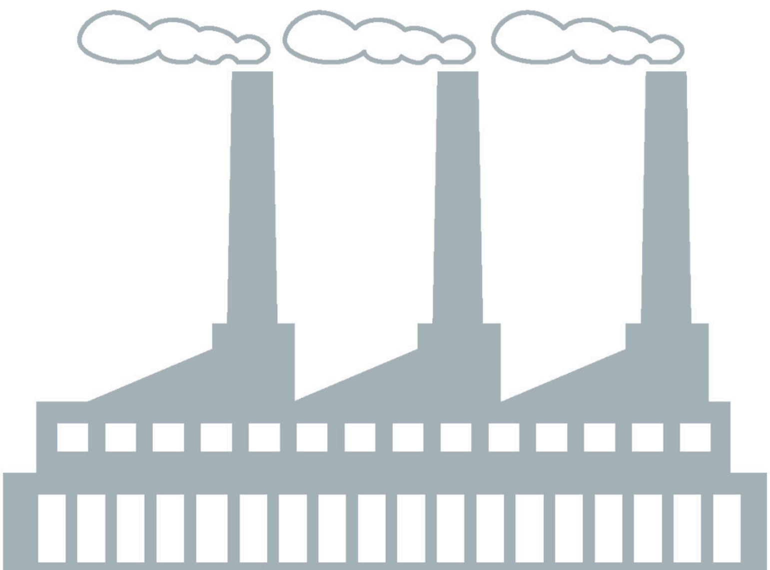
A sales outlet is the place where a product or service is sold, such as physical outlets or e-commerce websites. Sales channels are the merchants, agents, distributors, and platforms that take a product from the seller and bring it to the consumer, such as Amazon or TV shopping channels like QVC.

38%

revenue growth globally at online retailer Amazon in 2020

Main distribution channels

A product reaches the marketplace through one of four main types of distribution channels. The most suitable distribution channel is usually dictated by where customers prefer to buy the product.



Producer

A producer chooses the distribution channel, or a combination of channels, that will maximize the number of customers it can reach while keeping costs as low as possible.

Selling direct to consumers

Product is sold directly by the producer, usually online, and delivered to customer without intermediary.

Selling through retailers

Goods are delivered by producer directly to retail outlets; retailer adds a markup onto the price it pays to producer.

Selling through wholesalers and retailers

Products are distributed in two stages: by producer to wholesaler and then wholesaler to retailer.

Selling through an agent

Products are distributed in three stages: from producer to agent, from agent to wholesaler, and then on to retailer.

PROS AND CONS OF USING INTERMEDIARIES

Pros

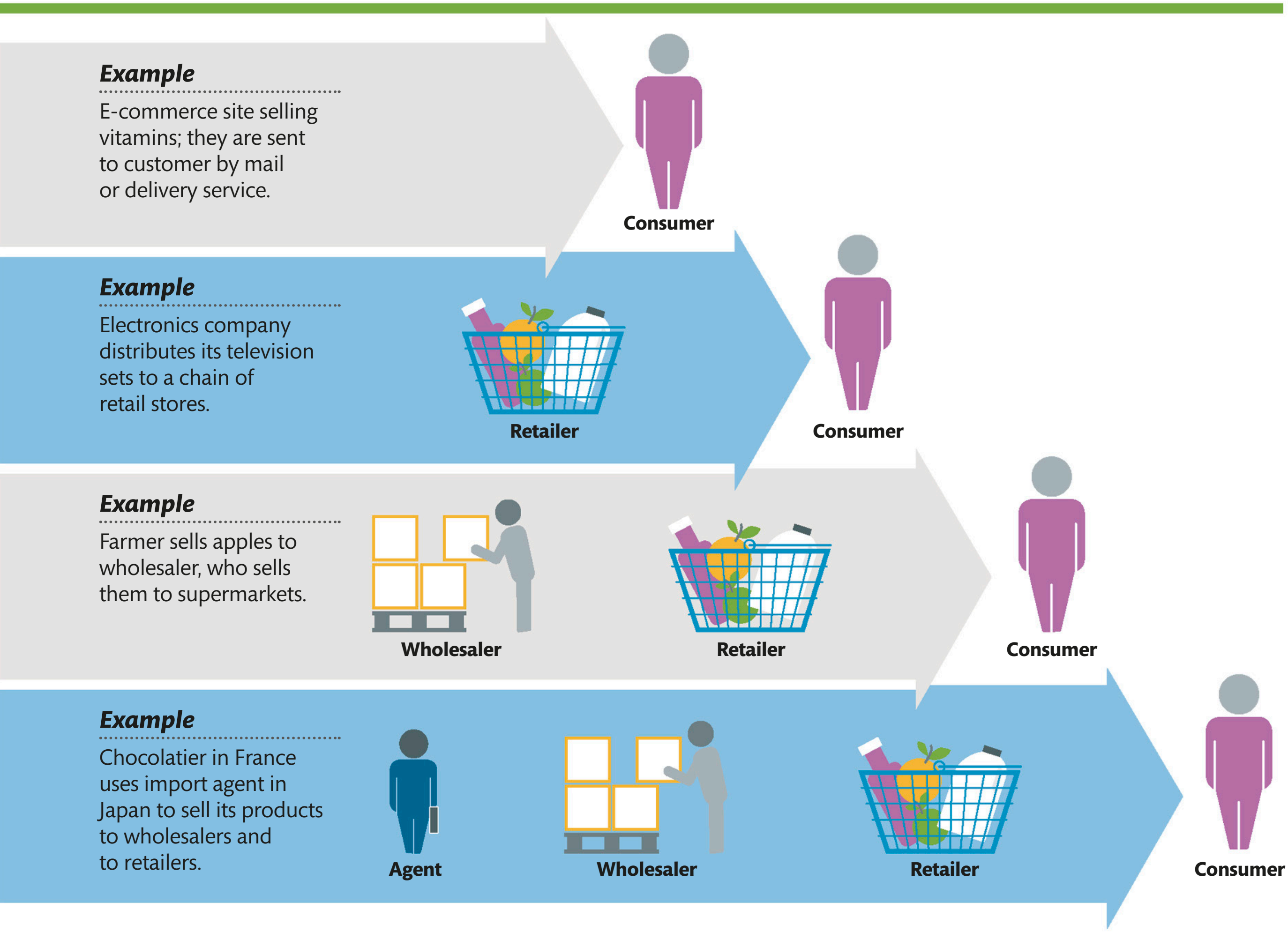
- Allows wider market coverage so producer can reach more customers, especially those in distant areas.
- Minimizes distribution cost for producer, as intermediaries are responsible for this service.
- Provides producer with specialized knowledge of customer buying habits as well as delivery logistics.

Cons

- Raises difficulty of making direct communication with customers to learn about their preferences.
- Increases the risk of slow, inefficient delivery, especially if several intermediaries are involved.
- Takes away control over how products are handled and displayed at point of sale.

NEED TO KNOW

- **Channel margin** The cost intermediary adds to producer's selling price, which is added to price paid by customer
- **Push strategy** Method in which producer promotes products to wholesalers, wholesalers to retailers, and retailers to customer
- **Pull strategy** Use of advertising and promotion to sell to customer



Promotion

Promotion is necessary for generating interest in and sales of a product or service. A complex and expensive part of the marketing mix, it involves communicating to customers and influencers, such as peer groups.

How it works

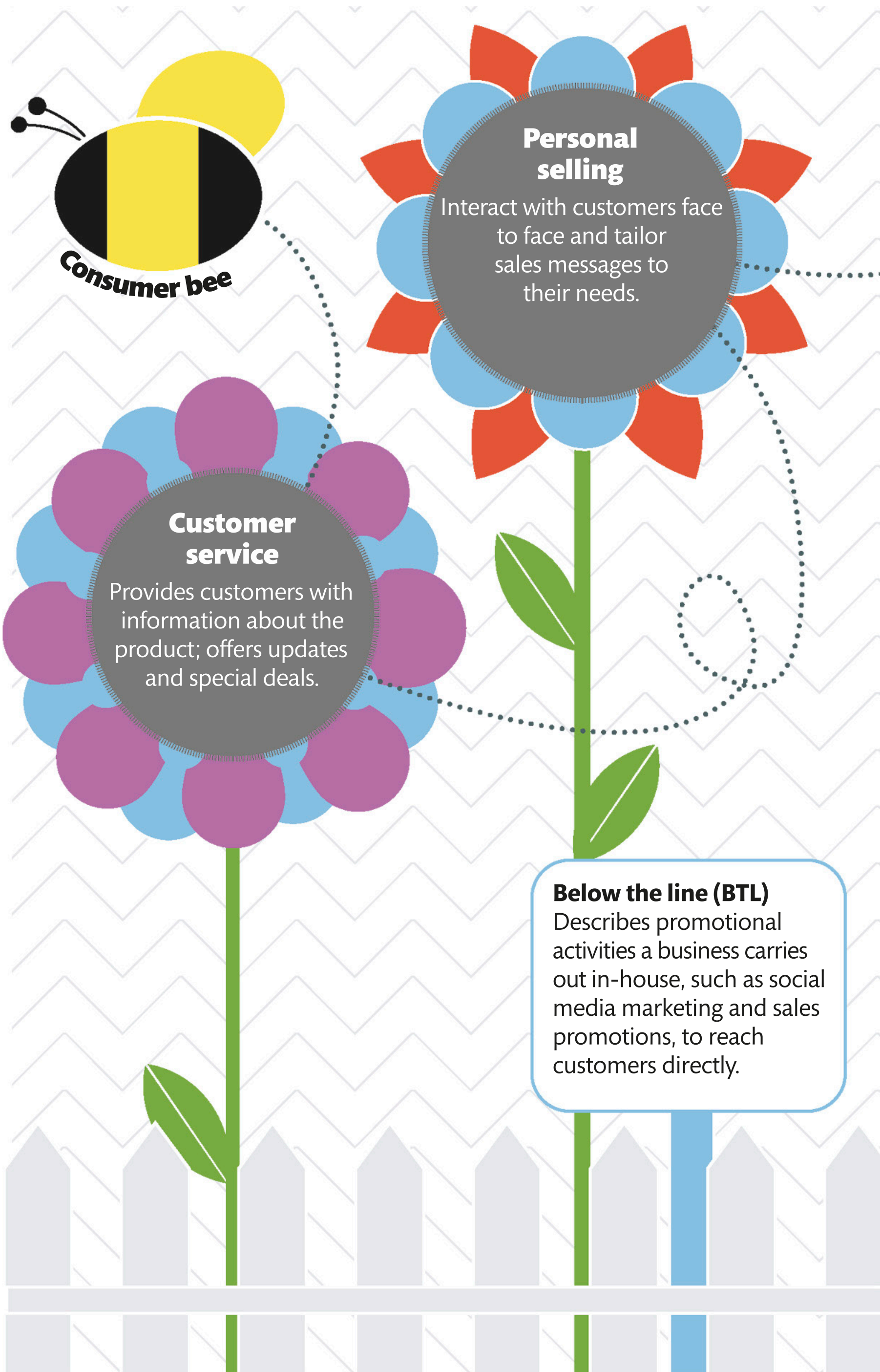
The primary purpose of promotion is to boost sales by attracting new customers while enticing existing ones to try out something new. Most companies use a number of communication activities to inform and remind their target audience of a product's benefits (*see pp.196–231*).

One of the long-term benefits of communicating with customers is that it helps build brand loyalty, but be aware that rules apply to the use of personal data.

NEED TO KNOW

- **Integrated Marketing Communication (IMC)** Promotion of the same brand message across all media channels
- **MarCom (Marketing Communication)** Full range of promotional activities used to reach out to the market

73% of marketers say social media marketing has been effective for their business.



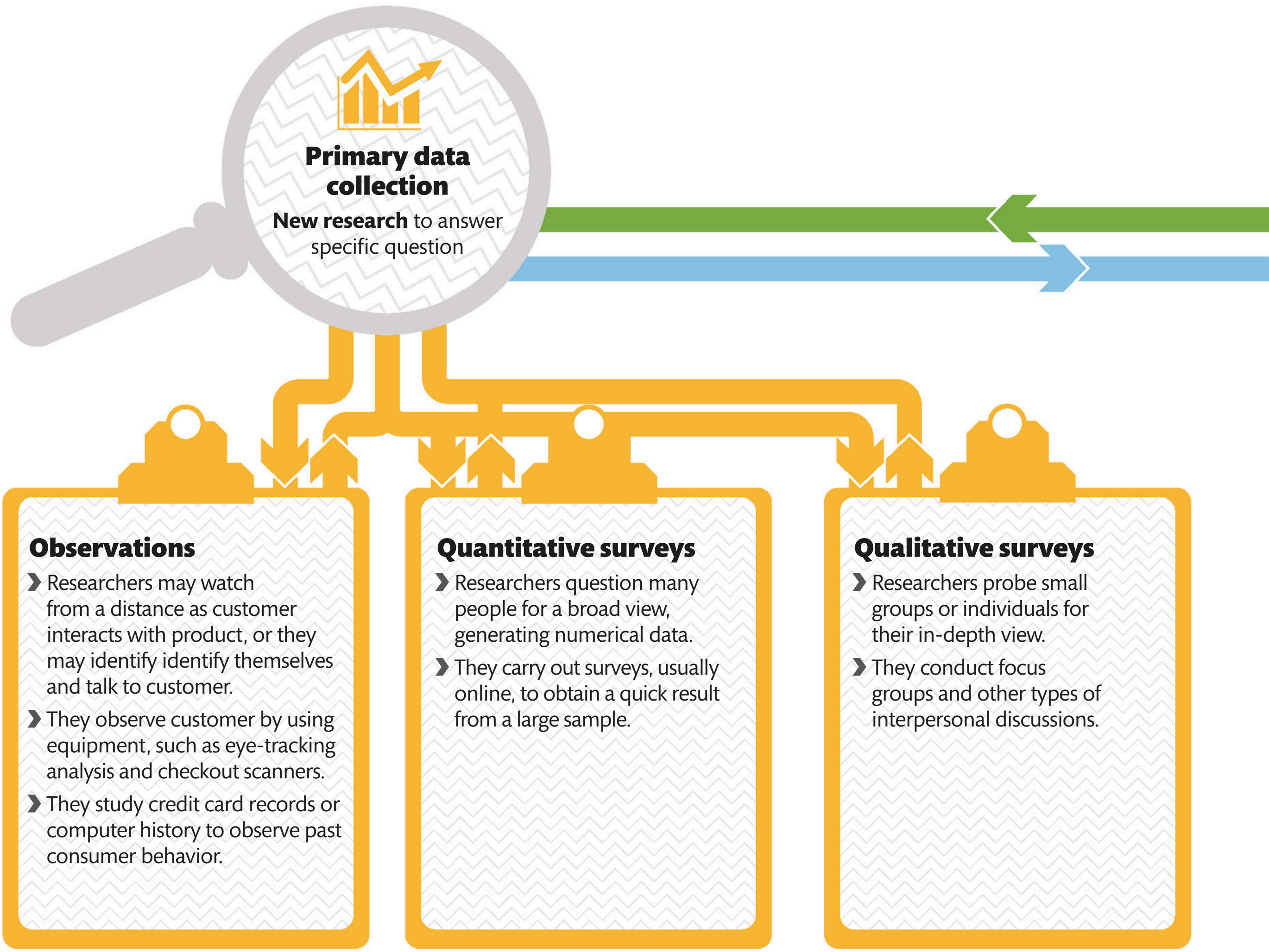

Advertising
Run ad campaigns through media channels most likely to reach target market and stick to budget appropriate for the product.
Direct marketing
Send product offers and information directly to the potential consumer via social media or email.
Interactive marketing
Build long-term relationships with customers using two-way communication, especially online.
Sales promotion
Entice customer with offers, free samples, gifts, competitions, packaging, and point-of-sale displays.
Public relations
Generate positive interest by pitching content to media or getting endorsements from influencers.
Above the line (ATL)
Refers to online and offline advertising a business pays for to target customers.

Market research

Asking customers what they think about a product or service is a vital part of the decision-making process for marketers. Research offers insights into how a product might sell and lowers the risk of marketing.

How it works

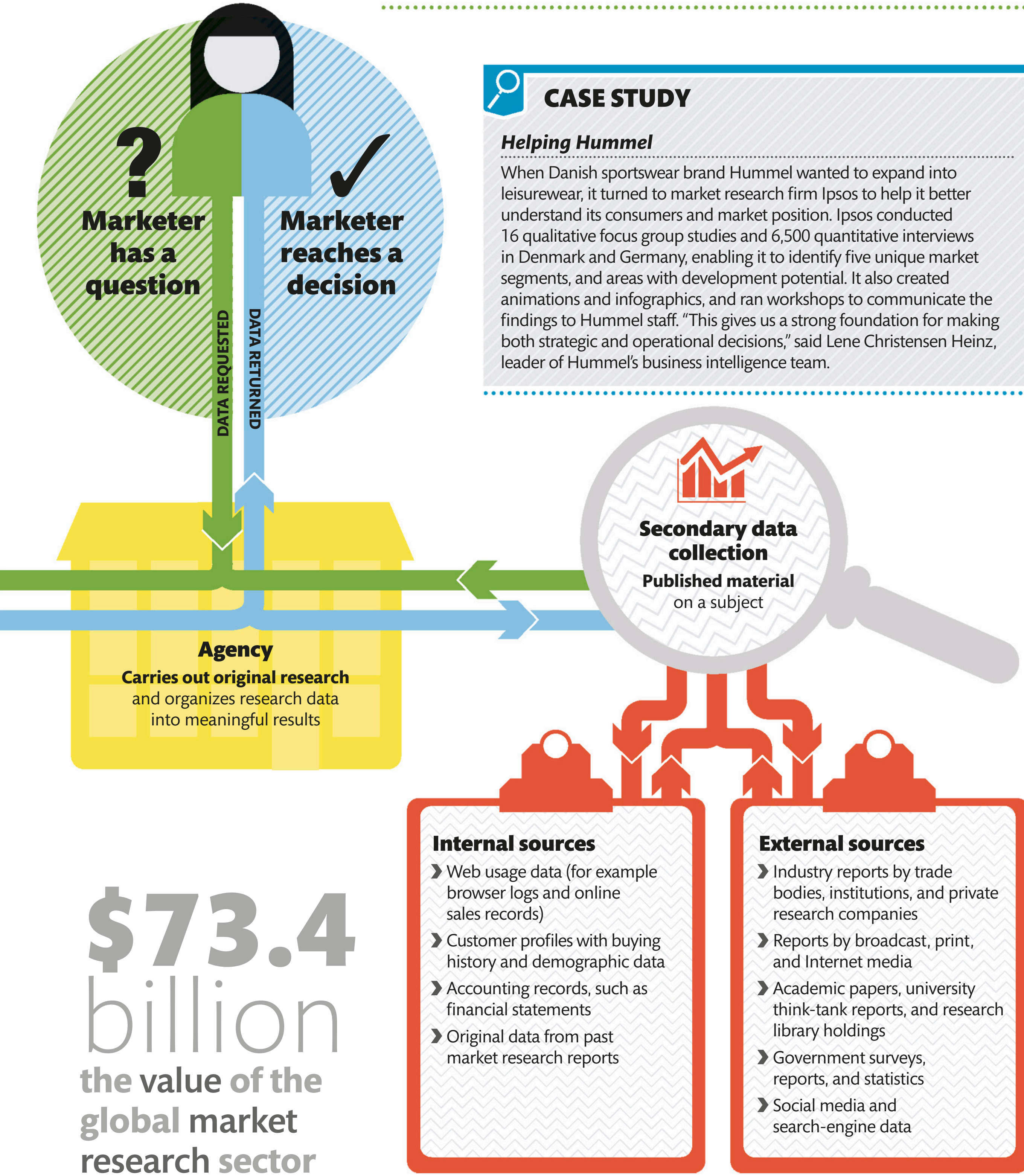
Market research is used to make decisions throughout the entire business planning cycle, from generating ideas to evaluating solutions. Researchers use a variety of data sources, including internal business information, primary (new) research, and external sources, such as social media. Primary research is broken down into quantitative and qualitative. Quantitative is numbers-focused and often involves asking fixed questions to large groups. Qualitative is more exploratory and is about understanding topics in depth among smaller groups. Marketing departments use both types of research, depending on the specific business questions they want answered.



CASE STUDY

Helping Hummel

When Danish sportswear brand Hummel wanted to expand into leisurewear, it turned to market research firm Ipsos to help it better understand its consumers and market position. Ipsos conducted 16 qualitative focus group studies and 6,500 quantitative interviews in Denmark and Germany, enabling it to identify five unique market segments, and areas with development potential. It also created animations and infographics, and ran workshops to communicate the findings to Hummel staff. “This gives us a strong foundation for making both strategic and operational decisions,” said Lene Christensen Heinz, leader of Hummel’s business intelligence team.



$73.4 billion

the value of the global market research sector

Market segmentation

In order to make decisions about who to sell their product to, marketers try to identify distinct groups of consumers with similar wants and habits who together form a "segment" of the market.

How it works

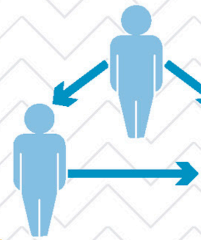
Marketing departments use a strategy of market segmentation to find the potential customers who are most likely to buy a particular product, thereby increasing the chances of a successful product launch. They divide a broad group of consumers into subgroups based on many factors, including age, lifestyle preferences, location, family structure, household income, and occupation. This process narrows down a potentially huge market into segments, allowing marketers to identify the ones more inclined to buy a given product. For example, after applying this strategy, a company trying to launch premium-price organic baby food realizes that instead of marketing to all women who have young children, it should aim its product at working mothers with children under six months, above-average incomes, and an interest in healthy eating.

✓ NEED TO KNOW

- **Baby Boomers** Section of population born between 1946 and 1964
- **Generation X** People born between 1966 and 1980
- **Millennials** Section of population born between 1980 and mid-1990s
- **Generation Z** People born between the mid-1990s and the early 2010s

Defining market groups

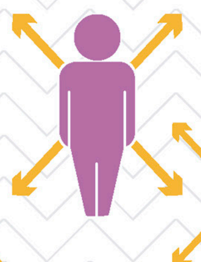
To establish different consumer groups, marketers create five segments and focus on each individually. Besides identifying groups by geography and demographics, marketers also explore psychology to ascertain how consumers behave, so that they gain a better idea of which products might appeal to which consumer groups. *See also pp.258–261.*



Behavioral

Focuses on behavioral patterns when it comes to shopping. Understanding this helps marketers adapt campaigns to target specific groups. Potential focus areas include:

- Brand loyalty
- Regularity of purchases
- Credit card usage
- Typical expenditure
- On- or offline shopping
- Heavy product use

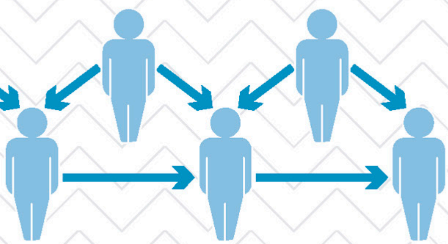


> "Market segmentation is a natural result of the vast differences among people."
>
> Don Norman, *cognitive science researcher and professor*

Sociographic

Identifies individuals' connections on social media or membership in political and other groups, helping marketers learn about consumers' passions and interests. Potential focus areas include:

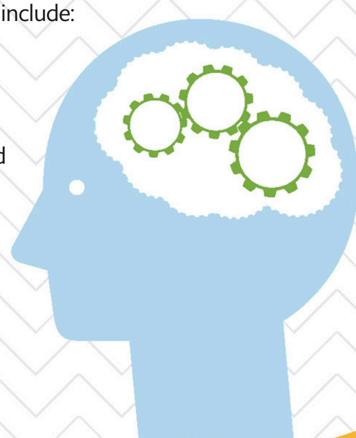
- Group memberships
- Number of friends on social media

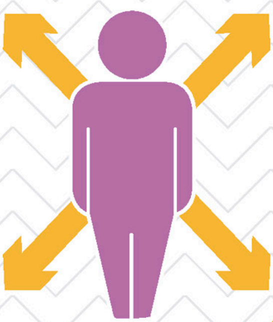


Psychographic

Focuses on consumer's interests, values, and opinions to help marketers develop relevant messages and find the right media channels to target a segment. Potential focus areas include:

- Risk taker
- Charitable
- High achiever
- A tendency toward expensive tastes
- A preference for email contact





Geographic

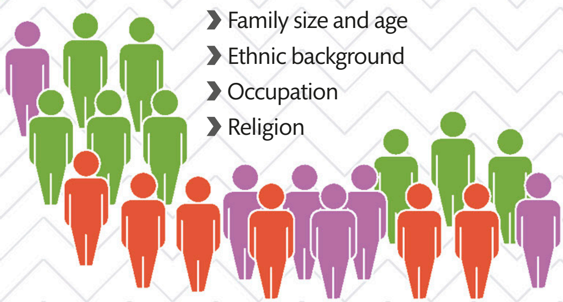
Concentrates on a customer's place of residence, so that any product launched is made relevant to their environment. Potential focus areas include:

- Zip code
- Continent
- City
- Neighborhood
- Population density
- Climate

Demographic

Uses basic consumer data, such as gender or age, to accurately categorize needs and target products appropriately. Potential focus areas include:

- Income
- Nationality
- Family size and age
- Ethnic background
- Occupation
- Religion

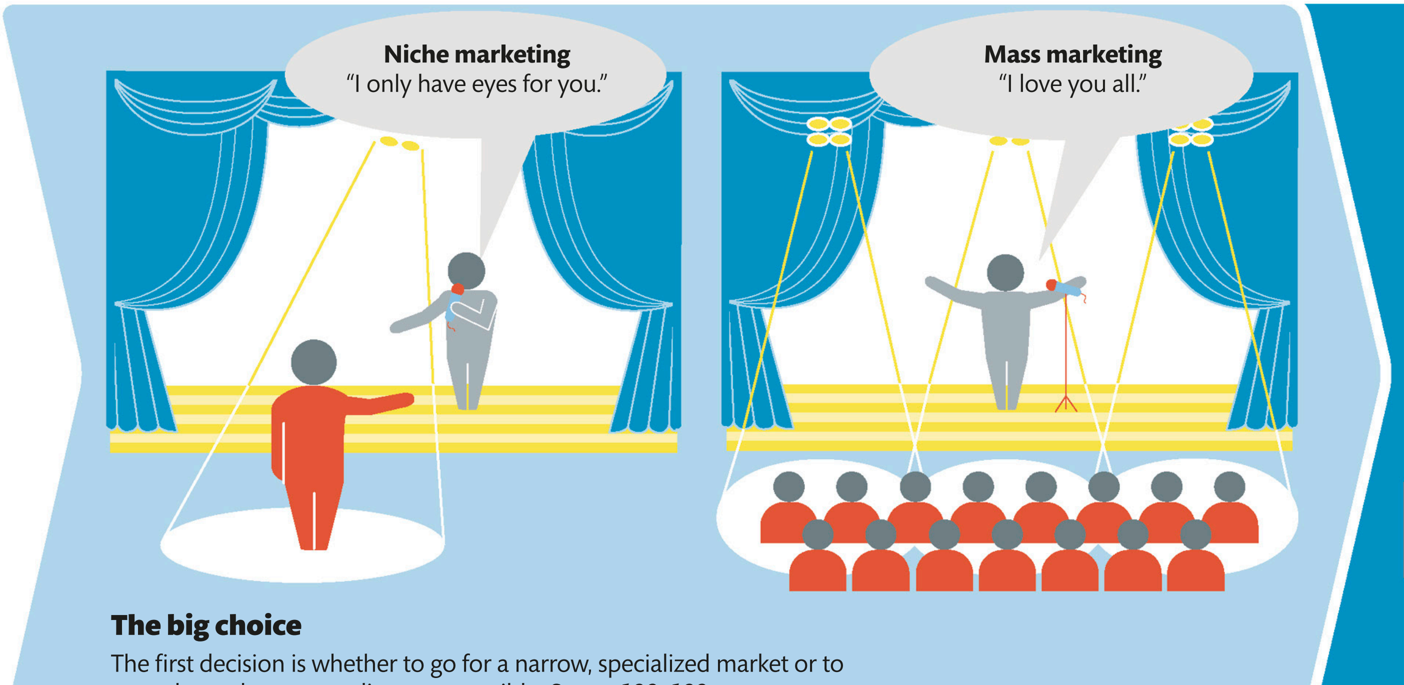


Marketing approaches

Every product launch requires strategic planning to make sure messages about a new product reach the right types of consumers, are communicated through the most effective combination of channels, and have the most relevant content and style. Once marketers have researched the market and defined their target audience, they face several key decisions on how to make their approach.

Types of approaches

Whom to target and how to go about it are crucial to success. Marketers may use several complementary approaches to different groups of potential consumers. Rather than sending the same message via different media, they usually adjust the tone and style of the marketing pitch to suit the channel as well as the target consumer.

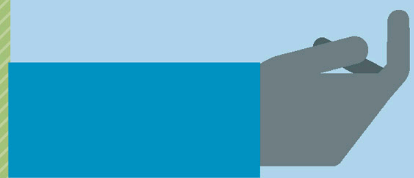


The big choice

The first decision is whether to go for a narrow, specialized market or to appeal to as large an audience as possible. *See pp.198–199.*

89%

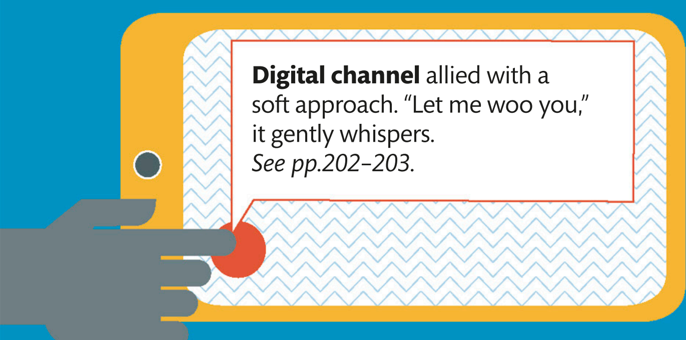
of women worldwide say they control or share the shopping for daily needs.



Engagement marketing
"Come dance with me."
It entices the customer to collude in product sales.
See pp.204–205.

Sensory marketing
"Wake up and smell the roses."
It seduces the customer with sights, sounds, and smells.
See pp.206–207.

Traditional channel allied with a dominating style. "Let me tell you," it blares.
See pp.200–201.



Digital channel allied with a soft approach. "Let me woo you," it gently whispers.
See pp.202–203.

Relationship marketing
"Let's be friends." It builds a rapport with its audience of consumers. *See pp.208–209.*

How to tell the customer

Marketers often get the best of both worlds by using traditional and online channels in varying styles.

Making a move

Turning the buying transaction into an experience the consumer enjoys can help sell a product.

Niche vs. mass marketing

Two fundamental choices traditionally face marketers: whether to try to sell a product with broad appeal to as many people as possible or to focus on selling a tailored product to a defined group.

How it works

Both niche and mass-marketing strategies offer businesses the potential to make a high return on investment. A niche approach generally works on the basis of low-volume sales at a premium price to a specific group of consumers, while a mass approach tends to use heavy promotion to a wider audience and aims to achieve high-volume sales.

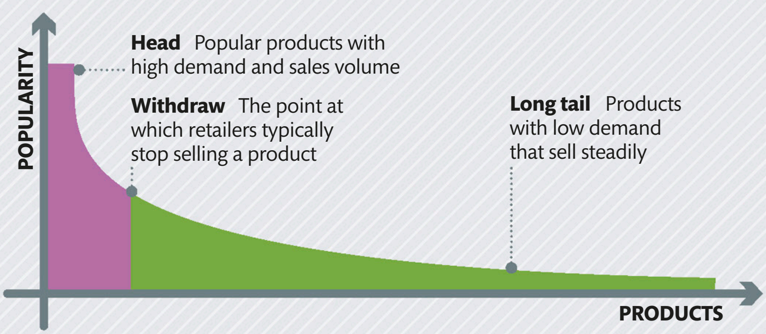
In reality, businesses tend to mix up both approaches, launching a niche product and then expanding it to a mass market. Marketers also use Internet channels to promote the same product to different groups of customers within a mass audience.

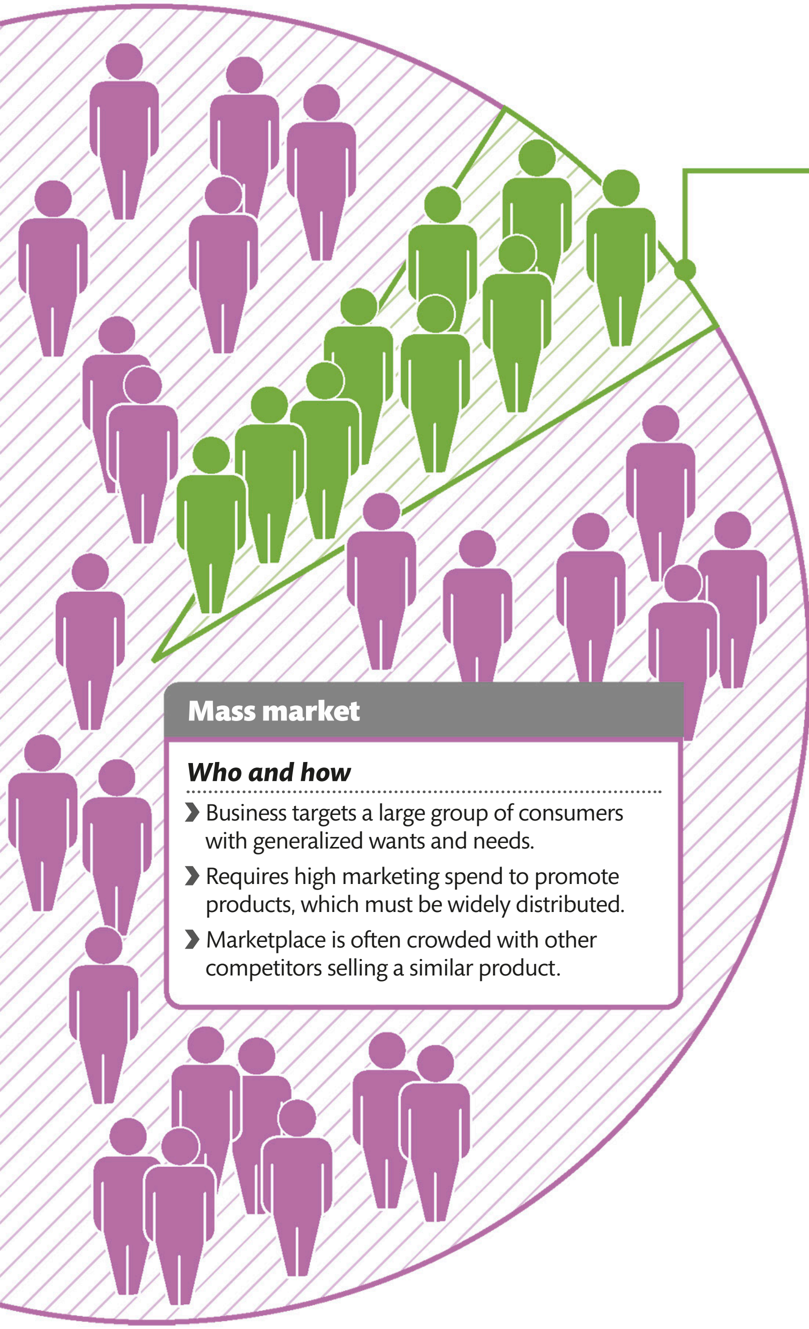
20% **of sales can make up to 80% of profit.**

NEED TO KNOW

Long-tail marketing

Coined by *Wired* magazine editor Chris Anderson, the term "long-tail marketing" takes its name from a demand curve (see below) depicting products with low demand or sales volume—niche products—that continue to sell and make profit over time.





Niche market

Who and how

- Business targets a select group of consumers with specific needs and wants.
- Customers are often prepared to pay a premium price for an uncommon product.
- Sales volume of niche product is low and so does not benefit from production economies of scale (manufacturing large quantity to reduce the unit cost of production).

Mass market

Who and how

- Business targets a large group of consumers with generalized wants and needs.
- Requires high marketing spend to promote products, which must be widely distributed.
- Marketplace is often crowded with other competitors selling a similar product.

HYBRID APPROACHES

Using social media to identify and reach more than one target market, marketers have developed hybrid approaches that are more flexible than conventional niche or mass-market positioning of products.

Mass market

An unfocused strategy that aims at the broadest customer base.

Large segment

Channels marketing resources to one large segment of the mass market.

Adjacent segment

Once large segment is fully penetrated, product expands into related segment.

Multi segment

Markets to several segments at once, with a customized strategy for each.

Small segment

Markets to a small segment with few competitors, if resources are limited.

Niche segment

Focuses marketing resources on a specific group of customers.

Mass customization

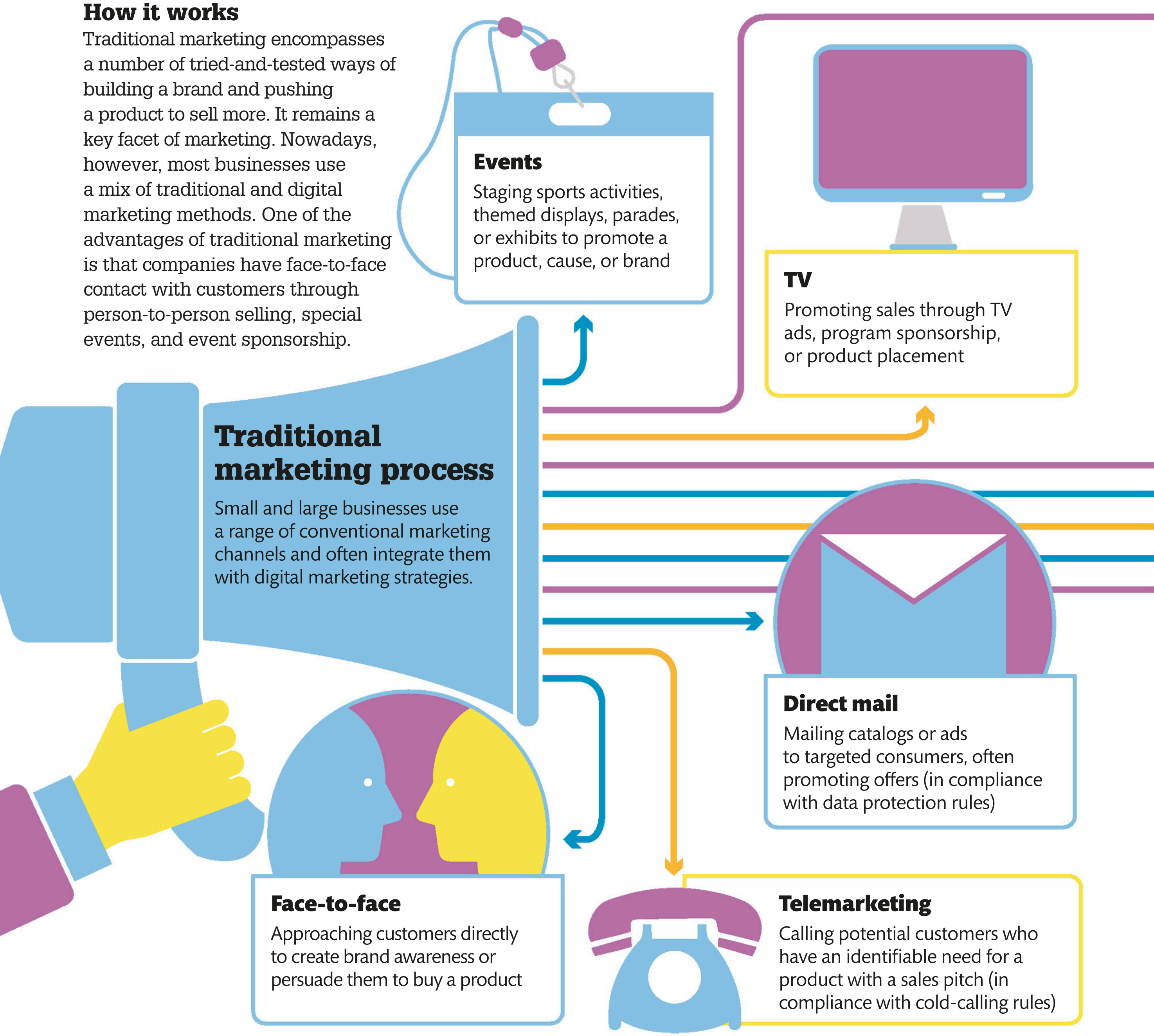
Customizes a strategy for each subsegment within the mass market.

Traditional marketing

Before the digital age, marketers relied exclusively on nondigital channels, such as TV, radio, and print media, as well as direct mail, events, and cold-calling, to convey their message to the consumer.

How it works

Traditional marketing encompasses a number of tried-and-tested ways of building a brand and pushing a product to sell more. It remains a key facet of marketing. Nowadays, however, most businesses use a mix of traditional and digital marketing methods. One of the advantages of traditional marketing is that companies have face-to-face contact with customers through person-to-person selling, special events, and event sponsorship.



Traditional marketing process

Small and large businesses use a range of conventional marketing channels and often integrate them with digital marketing strategies.

Events

Staging sports activities, themed displays, parades, or exhibits to promote a product, cause, or brand

TV

Promoting sales through TV ads, program sponsorship, or product placement

Direct mail

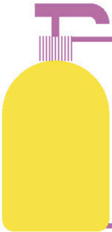
Mailing catalogs or ads to targeted consumers, often promoting offers (in compliance with data protection rules)

Face-to-face

Approaching customers directly to create brand awareness or persuade them to buy a product

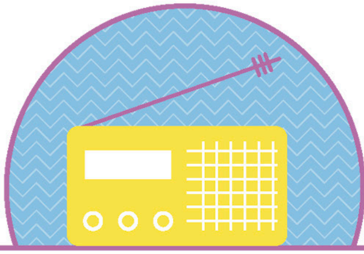
Telemarketing

Calling potential customers who have an identifiable need for a product with a sales pitch (in compliance with cold-calling rules)

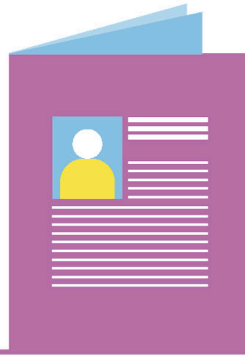


Product samples
Offering free samples of a product to customers, giving them the opportunity to try it before making a purchase—an effective way to launch new products and build a customer base

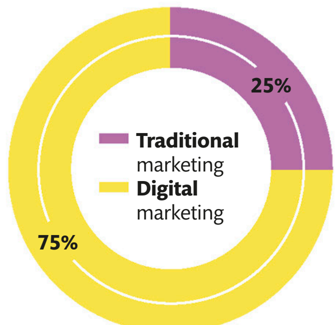
Billboards
Renting large outdoor advertising spaces to market products; cost depends on the size of the space, its visibility, and the amount of traffic that passes the location

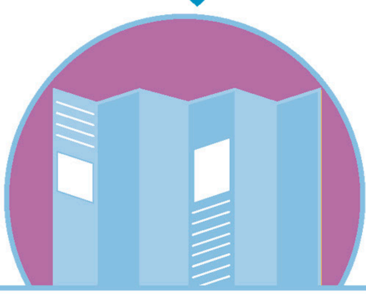


Radio
Using commercial slots on radio to promote products either locally or nationally, depending on the station's reach



Newspapers and magazines
Buying space in print media to run advertisements or creating advertorials to market products or services





Brochures and flyers
Promoting through mailing or locally hand-distributing printed materials to promote businesses

Networking
Interacting with other people at special events to develop professional contacts

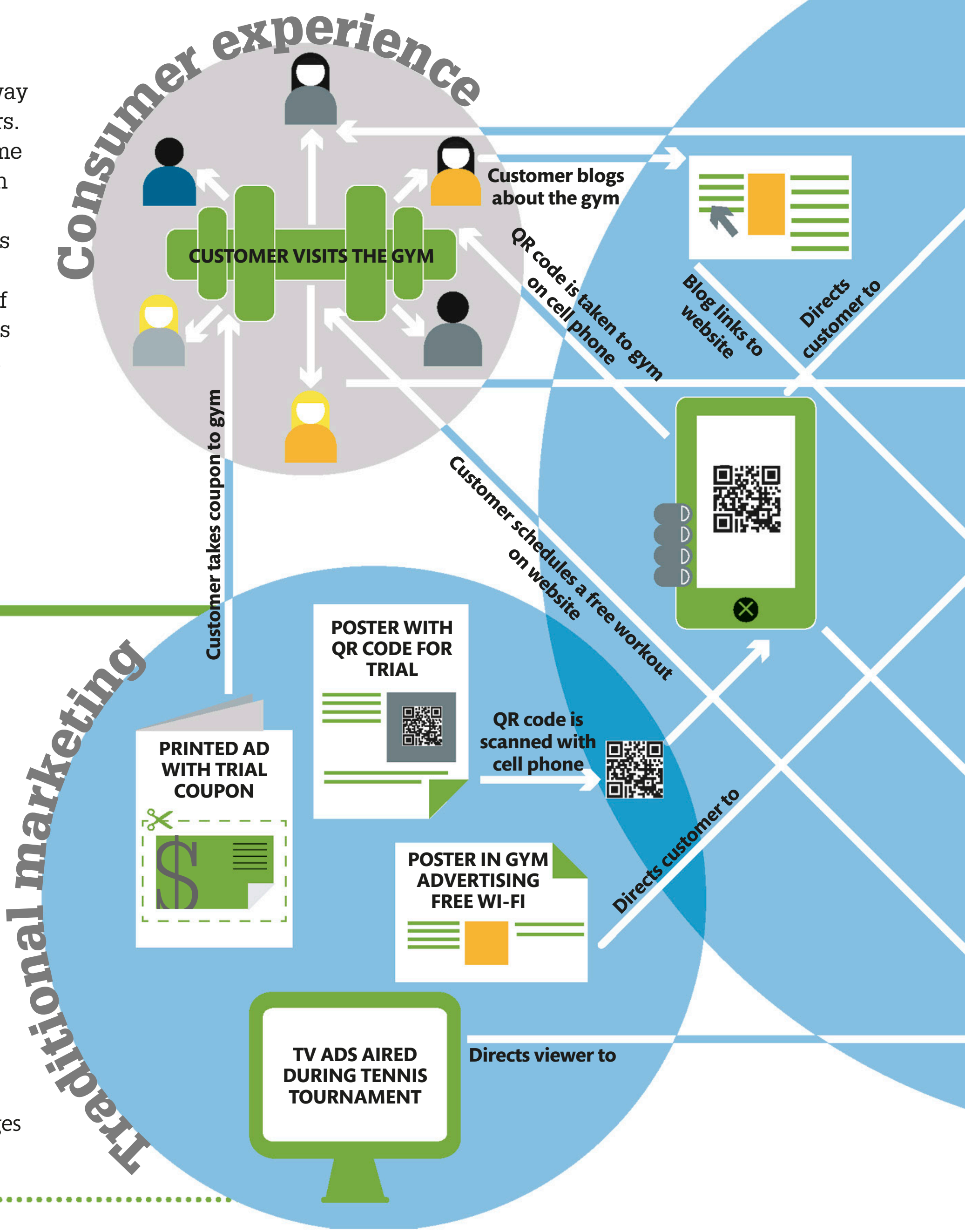
70% higher brand recall by people exposed to direct mail ads rather than digital ones

Digital marketing

Using the Internet, marketers can connect directly and instantly with current and potential customers to build brand recognition, collect data, and encourage word-of-mouth recommendations.

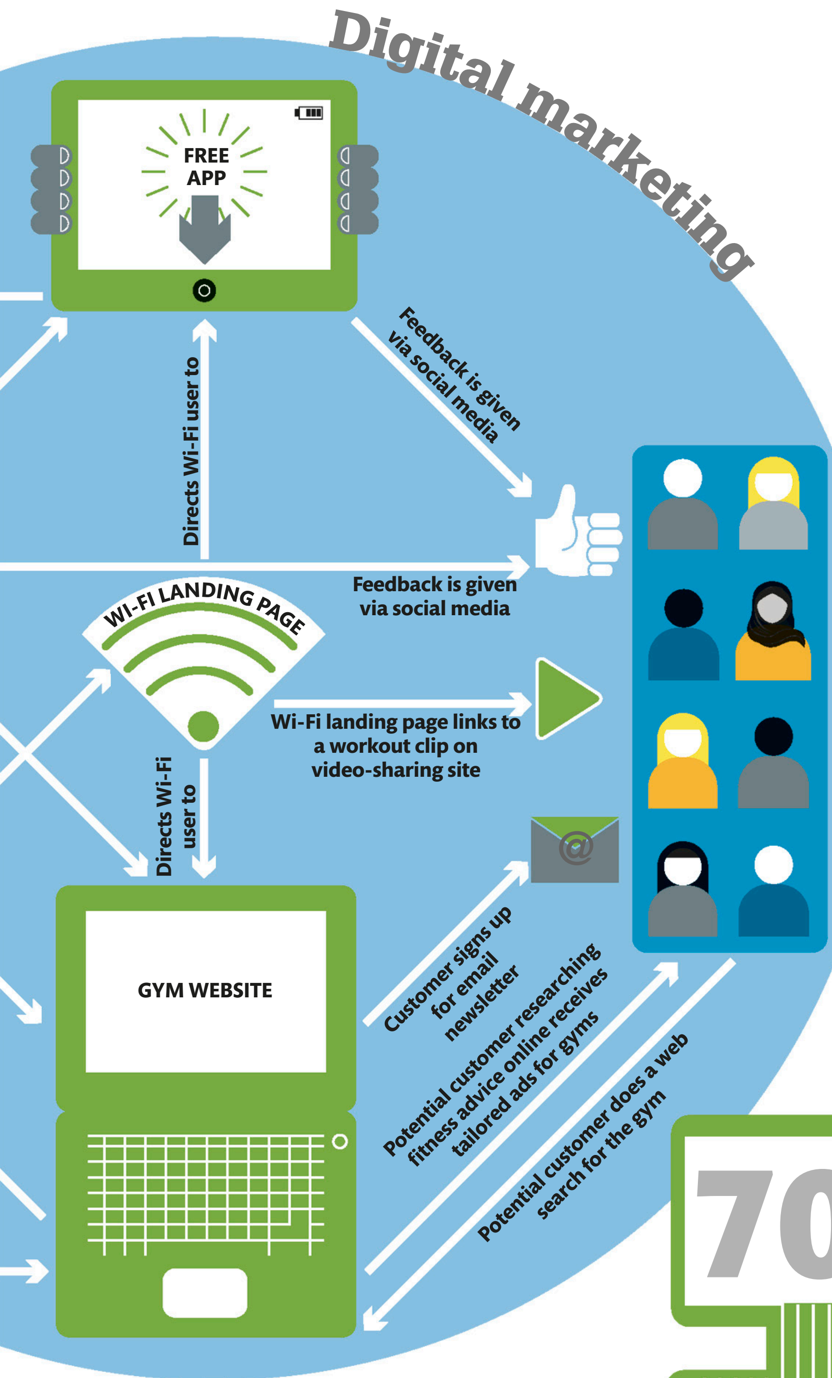
How it works

Unlike traditional offline marketing, digital marketing gives a business direct, two-way communication with customers. Digital marketing employs some conventional approaches, such as "pop-up" or "banner" ads on web pages, but it also relies heavily on the power of social media for raising awareness of a product or brand. This makes it harder to measure return on investment. Digital marketing is often used in conjunction with traditional marketing techniques, a hybrid known as "tradigital" marketing.



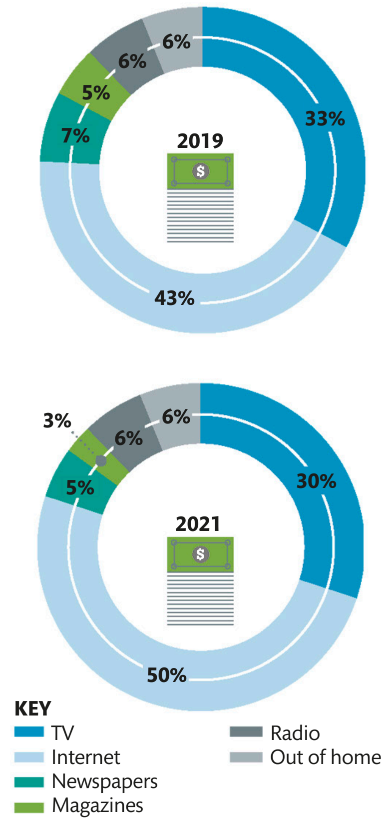
Tradigital in practice

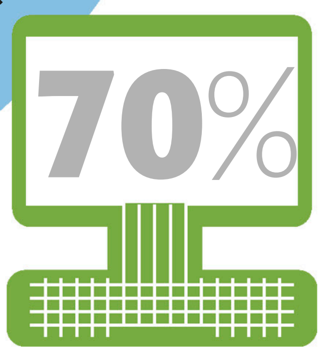
A new health club is launched using a tradigital approach to marketing. TV ads are aired with a call to action to visit the gym's website and schedule a free workout with a fitness trainer. Print ads feature a coupon or a QR (quick response) code to scan and present at the health club for a free trial. At the club, members get free Wi-Fi access. The Wi-Fi landing page has a link to the gym's free app. The club may also use pop-up ads, podcasts, email, and text messages to attract or retain members.



% SHARE OF GLOBAL AD SPEND BY MEDIUM

The Internet is expected to account for more than half of global ad spending in 2021 as the expenditure on print and TV ads continues to fall.





of advertising spending in China is set to go on digital ads in 2021.

Engagement marketing

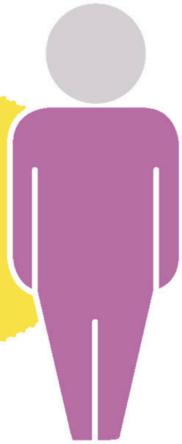
By involving customers directly in the development of a brand, marketers hope to build a strong two-way relationship with customers and win long-term loyalty.

How it works

Engagement marketing harnesses several online and offline strategies to draw a customer's interest and get them talking about products and services. This contrasts with the more traditional style of marketing in which a brand concept and product proposal are presented to the customer as fixed, to be either accepted or rejected. Engagement marketing, on the other hand, encourages customer input so that they feel closer to the brand. The goal is to lure potential customers to the website with an initial experience and then work hard to keep them there.

Start with a "wow" experience

Provide interesting, informative, or entertaining content to draw potential customers to a web page.



Sale

Once customer makes purchase, follow up with after-sale call, full of feel-good reinforcement.

New prospects

Offer incentives to existing customers for recommending product or sharing content.

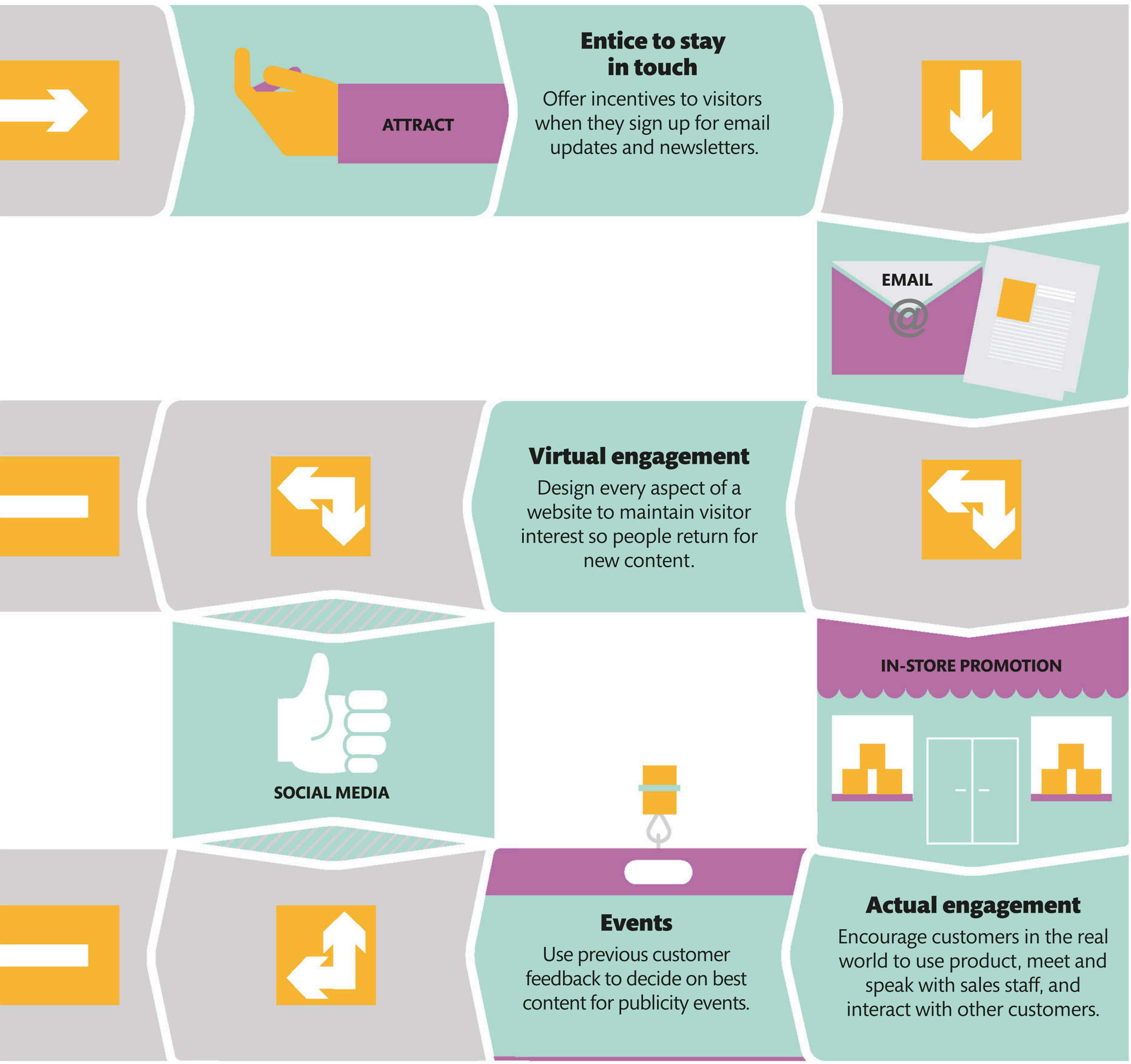
Social visibility

Post interesting and relevant content on social media and encourage dialogue.

NEED TO KNOW

- **"Sticky" customers** Consumers who are loyal to a company and return to make more purchases
- **Decision simplicity** Ease with which consumers can find trustworthy information about a product
- **Churn rate** Percentage of customers who cut ties with the company in any given time period
- **WOM** Word-of-mouth marketing, which relies on satisfied customers recommending products to others

72% of people are more likely to be loyal to a brand if it offers a personalized experience.



Sensory marketing

Sensory marketing targets multiple senses to sway purchasing decisions. Based on research showing how the brain responds to sensory input, this type of marketing acts covertly on the customer.

How it works

Sensory marketing is most obviously used by the food and drinks industries, but its use extends to diverse products and services: computers designed with tactile materials, hotels scented to relax customers, and even fireworks displays featuring edible confetti.

Typical channels for sensory marketing include field marketing, such as in-store events, samples, person-to-person sales, direct mail, and product delivery. For online businesses, however, finding a way to use it remains a challenge.

Sight

Technology is making advances with this, the most stimulated sense in marketing, by using optical illusions, digital effects, 3-D, and 360-degree photography.

Touch

Marketers use 2-D and 3-D textural print techniques for promotional materials and packaging as well as to sell products with tactile appeal.

Smell

Customers are willing to pay more for a product sold in an environment that is scented appealingly.

72%

of consumers born from 1980 to 1996 value experiences over material items.

Taste

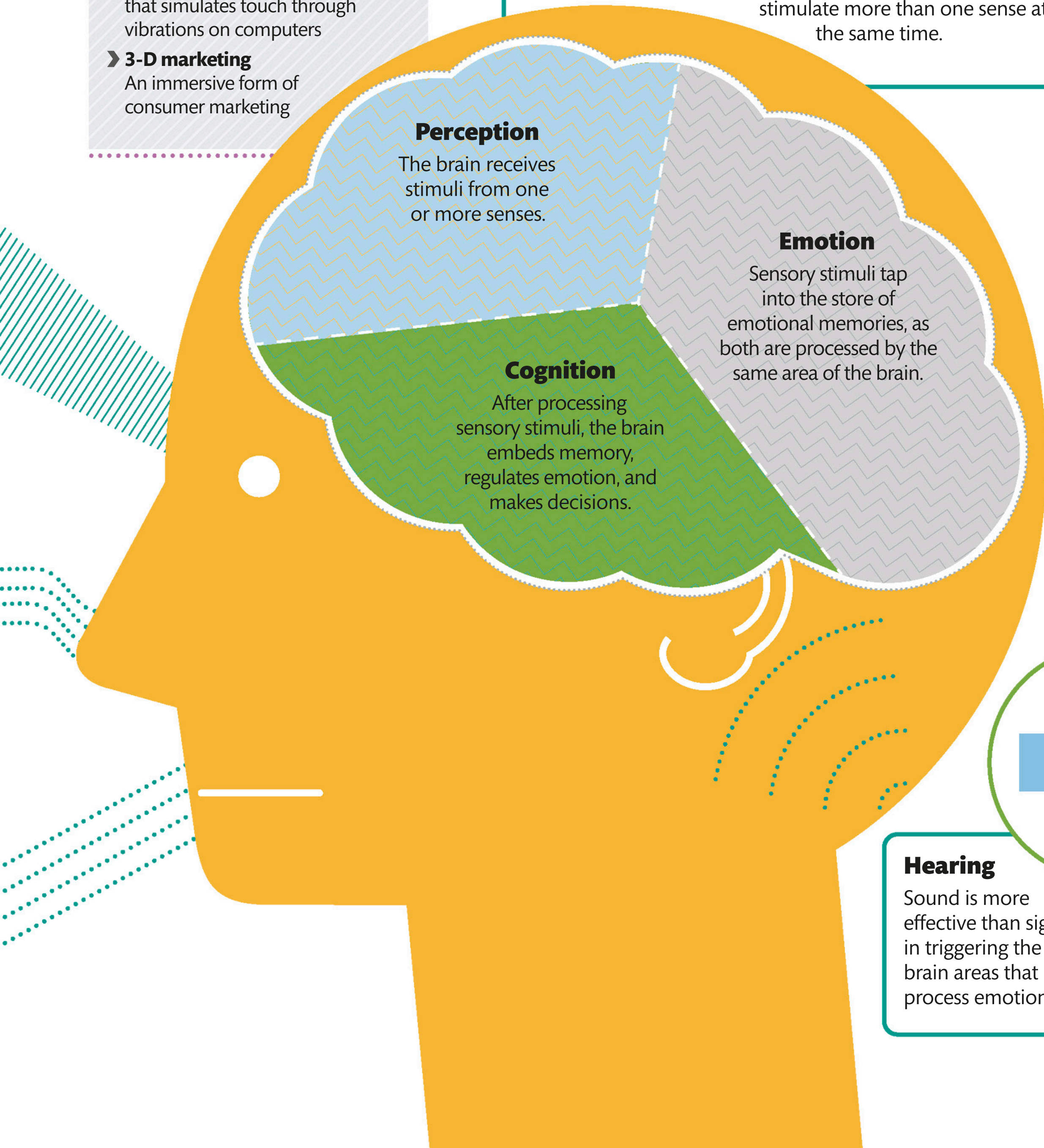
Taste sensations can be enhanced or subtly altered by combining them with touch, sight, and especially the closely linked sense of smell.

NEED TO KNOW

- **Sensory testing** Assessment of products by panel members with exceptional sensory perception
- **Haptic technology** Invention that simulates touch through vibrations on computers
- **3-D marketing** An immersive form of consumer marketing

Attitude, memory, behavior, and mood

The sensory input results in a short- or long-term effect on attitude, memory, behavior, and mood. This can be influenced by the intensity of sensory data and by using it to stimulate more than one sense at the same time.



Hearing

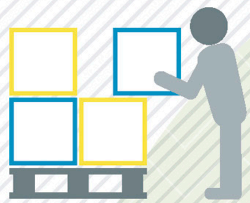
Sound is more effective than sight in triggering the brain areas that process emotions.

Relationship marketing

The strategy of relationship marketing is to develop and manage a trusting, long-term association with customers and other stakeholders who have links with the company.

How it works

Relationship marketing aims to replicate the type of interaction that village stores once had with their customers, offering a high level of personalized service to win them over for a lifetime. While small, local businesses naturally work this way, large corporations have now changed their focus from making the sale to relationships and from short-term reward to long-term gain. The marketer can extend the network beyond the engaged customer to include employees, suppliers, and others.



Supplier markets
Building a relationship of collaboration with suppliers makes good commercial sense.

Six markets model

Relationship marketing has established a strategy for communicating with the customer. This strategy defines six markets—not just traditional customer markets—where companies should direct their marketing efforts.

CASE STUDY

Starbucks

The strategy of coffee-shop chain Starbucks exemplifies effective relationship marketing. Centered on core customer and internal markets, it also involves suppliers, referrals, and recruitment (employee) markets.

Marketing to customers
- Social media
- Business crowdsourcing
- Familiarity with customers
- Loyalty program
- Reward card app
- Mobile payments

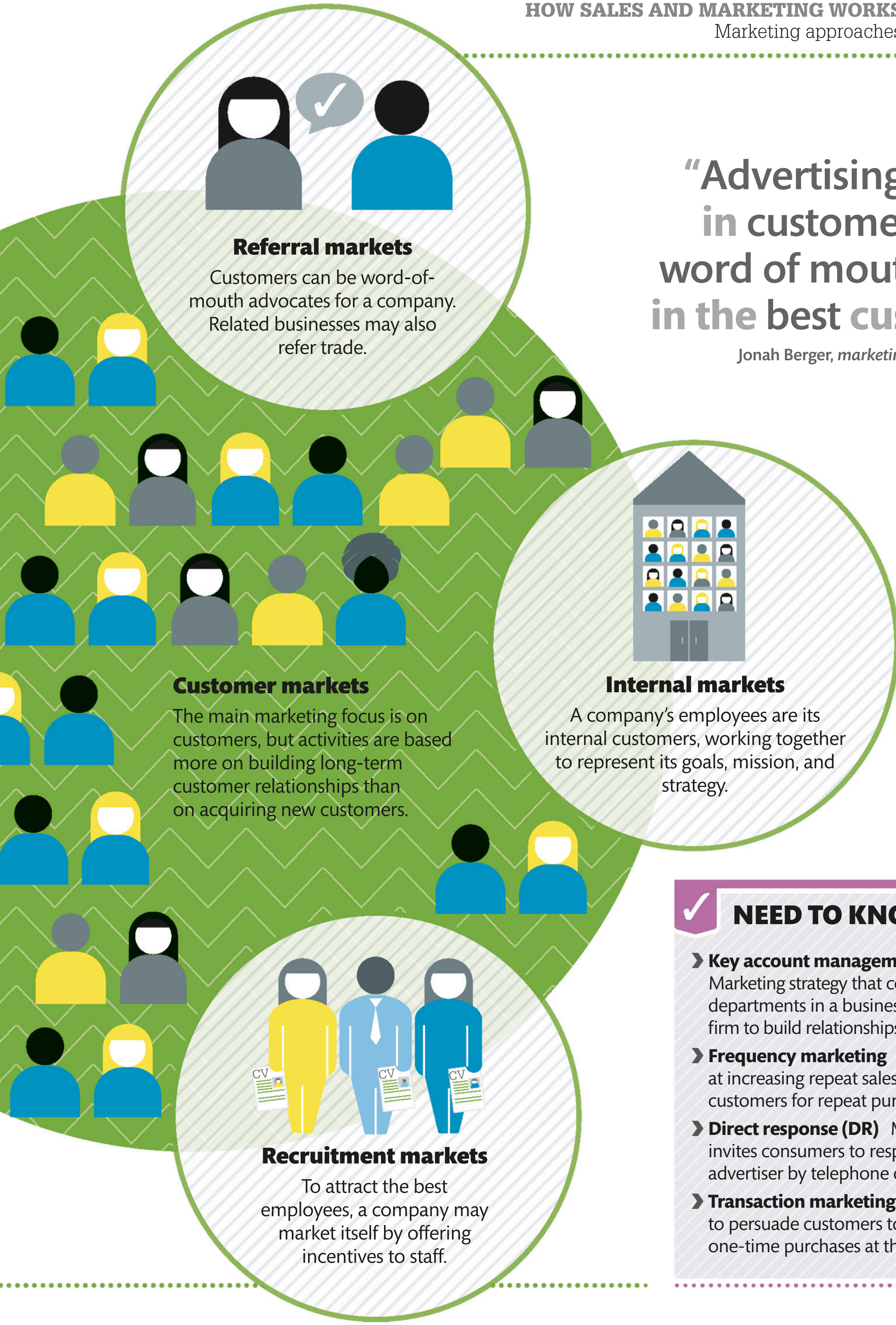
Marketing internally
- Barista training
- Tech development opportunities

Marketing via referrals
- Word of mouth
- Social media shares

Marketing to employees
- Stock options
- Medical insurance
- Partnership

Marketing to suppliers
- Fair-trade programs
- Quality control

Influence markets
To maintain good public relations, the company works with regulators and consumer or environmental groups.



> "Advertising brings in customers, but word of mouth brings in the best customers."
>
> Jonah Berger, *marketing professor*

NEED TO KNOW

- **Key account management (KAM)** Marketing strategy that coordinates departments in a business-to-business (B2B) firm to build relationships with major clients
- **Frequency marketing** Promotion aimed at increasing repeat sales by rewarding customers for repeat purchases
- **Direct response (DR)** Marketing that invites consumers to respond directly to advertiser by telephone or email
- **Transaction marketing** Strategy that aims to persuade customers to make additional one-time purchases at the point of sale

Outbound marketing

Also called interruption marketing, outbound marketing involves a marketer pushing a message to consumers. With this type of marketing, businesses typically reach out to a wide audience by paying for advertisements on various media channels. Although the audience may have no interest in the advertisement, outbound strategy relies on delivering a high-impact message and generating a response by creating familiarity through repetition.

Outbound marketing process

Outbound marketing takes a traditional approach to grabbing consumers' attention but may use both nondigital and digital media platforms. There are two stages to the outbound process. First, the company communicates a message to an audience and tries to convert them into customers; second, it analyzes the results to identify the channels and campaigns that have generated the most sales.

Broadcast

Marketers select a media channel with proven reach to the target audience and then communicate the message about brand or product to that audience.

Communication channels

- **Ads on prime-time TV** to find widest possible audience—ideal for raising brand awareness.
- **Presence at trade events** for increasing corporate visibility and reaching a business audience.
- **Banner ads and pop-up ads** on relevant Internet sites or attached to blogs that link to the company's website.
- **YouTube video ads** stay in the viewer's mind longer than static ads and so can be effective.
- **Sponsorship** of sporting or cultural events puts a name or brand in front of a large audience.

Convert

Marketers link offline outbound campaigns with digital channels as part of an overall strategy to persuade potential customers to respond.

Means of conversion

- **Radio advertisement** that repeats easy-to-recall phone number to elicit immediate action.
- **Online advertisement** that has prominent position on web page and clear click-through point that invites customers to click, find out more about product, and buy.
- **Flyer** distributed door to door that includes an appealing introductory offer on the product for a limited period of time.
- **Direct mail** that makes high-impact call for customer response or delivers strong novelty value; includes postage-paid reply form and customer service contacts.

86%
of businesses use video as a marketing tool.

Analyze

Marketers monitor the progress of outbound campaign, adjust the mix of media or other paid-for channels, and then measure campaign results.

Actions

- **Run control and test streams** to compare the success of different media or campaign strategies.
- **Examine click-through-rate** analytics, which look at how many customers have clicked through to find out about or buy product, to determine online ad success.
- **Analyze sales by outbound spend** to establish which channels offer the best return on marketing investment (ROMI).
- **Measure direct mail response rates**, including breakdown of different mailing lists or target demographics.

TYPES OF OUTBOUND MARKETING

Offline

- **Cold calling** Campaign can be more effective if conducted at the right time of day to suit target audience; message should be scripted carefully and delivered in a genuine tone. Be aware of rules governing its use. *See pp.218–219.*

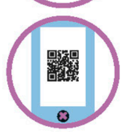
- **TV commercials** Although many consumers now switch off TV advertisements, they are familiar with and open to this type of media, and repetition gets the message across. *See pp.212–213.*

- **Radio** This medium is the world's most popular mass communication channel with a global reach and is ideal for outbound messages aimed at an international market. *See pp.212–213.*

- **Guerrilla marketing** The use of a creative and unconventional approach in high-traffic public places can be a cost-effective way to raise brand awareness. This is a form of engagement marketing. *See pp.204–205.*

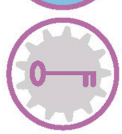
Online

- **Social media** The types of advertising on social media sites are increasing and include sponsored posts, promoted pins, and direct forms, such as banner ads and video ads. *See pp.228–229.*



- **Mobile technology** Advertising that is tailored for mobile devices takes the form of text and images, or both, to offer special deals to users; promotions are also made via apps. *See pp.214–215.*

- **Social lead targeting** This strategy taps into individual profiles from social media and tailors messages, which are sent via online networks, such as Twitter and LinkedIn.



- **Search engine optimization (SEO) keywords** Paying for popular SEO keywords relevant to a brand can improve exposure by raising it in Internet search-engine listings pages. *See pp.230–231.*

Traditional offline advertising

Offline advertising uses traditional media channels, such as magazines, TV, radio, and billboards, to market a product or service. Online advertising now rivals it as the dominant form of advertising globally.

How it works

The common criteria for both online and offline advertising are that businesses pay for ads that are intended to catch a consumer's attention with a brand or product message.

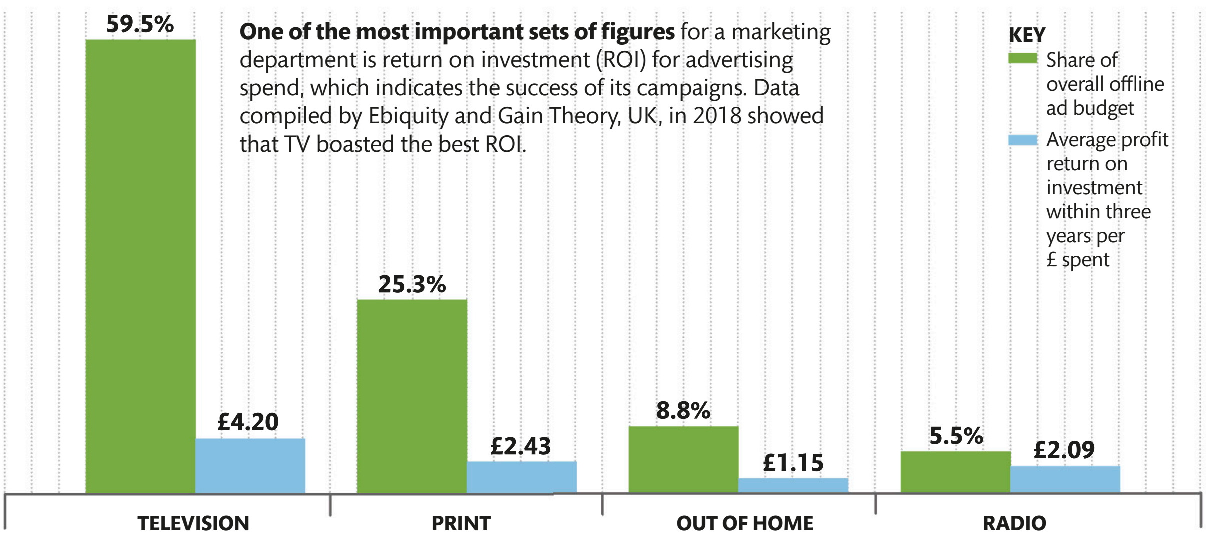
Businesses calculate the success of their advertisement by looking at the return on investment (ROI) for every ad dollar spent. And to maximize the ROI, they must make sure they choose the right channel for their target audience.

Marketers choose different channels according to the target market defined for the product or service being advertised. The choice may also be based on the ROI that a company has previously experienced for that channel. However, tracking the response rate of offline advertising is more difficult and less accurate than tracking online advertising (*see pp.214–215*).

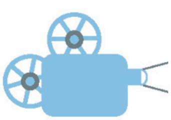
71% of advertising in India in 2021 was offline—but digital is catching up, growing 9% since 2019.

OFFLINE ADVERTISING AND RETURN ON INVESTMENT (ROI)

One of the most important sets of figures for a marketing department is return on investment (ROI) for advertising spend, which indicates the success of its campaigns. Data compiled by Ebiquity and Gain Theory, UK, in 2018 showed that TV boasted the best ROI.



Offline advertising channels

	Pros	Cons
Television 	Offers local, national, and global reach; mix of sound and vision creates high-impact message.	Expensive; ad repetition may cause viewer fatigue; viewers are likely to skip ads on recorded shows.
Radio 	Inexpensive; quick and easy production process; most stations play to specific demographic.	Competition for prime "commute" slots; radio on as background noise renders ad ineffective.
Newspapers 	Fast publication process; themed newspaper sections allow for more targeted advertising.	Ads compete for attention with other material on page; usually black and white; text-only readership has declined.
Magazines 	May remain in circulation for months; niche trade and special-interest titles allow focused advertising.	Real circulation figures hard to source; securing ad slot requires planning months in advance.
Direct mail 	Cost-effective; delivered straight to people's homes and offices; targets specific markets; can stand out more.	May be perceived as junk mail and instantly thrown away; response rate usually low; rules limit who you can target.
Billboards 	High reach makes channel cost-effective; advertiser's message is visible 24 hours a day.	Heavy competition for prime sites; format limits message length and complexity.
Movies 	Potential to impress with sophisticated, creative production; it has captive audience members.	Audience numbers limited; members may choose to enter theater after ads are shown.

✓ NEED TO KNOW

- **Television rating point (TVR)** Indicates percentage of target viewers in program audience
- **Cost per thousand (CPT)** Figure used to measure outlay to reach a thousand people via any channel
- **Advertising to sales ratio (A/S)** Method of measuring money spent on advertising and sales generated
- **Share of voice** Percentage of total activity claimed by one advertiser for a product sector

70%

of Europe's population watches television on a daily basis, averaging three hours and 39 minutes a day.

Online advertising

Marketers are increasingly advertising online to push marketing messages to consumers. Online channels include display and mobile technologies, email, search engines, and social media marketing.

How it works

When marketers advertise on the Internet, they have to choose both the form of the ad and a location that has an audience matching their target market. There are several advertising channels, but the two most often used are display advertising and search advertising.

Display advertising includes banners with text and images, which appear on websites known to be used by target consumers, such as news, social media, or video content sites. Online ad tracking aims to target ads more precisely, delivering more relevant content based on a consumer's Web activity.

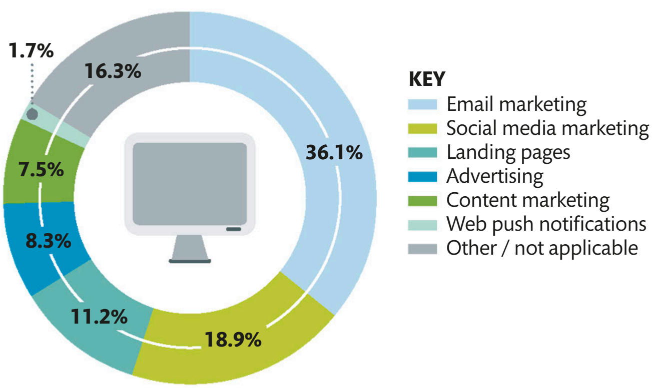
Search advertising places ads in the Web pages showing search-engine results. While display ads are likely to get more views overall, search ads have a better chance of reaching the target audience.

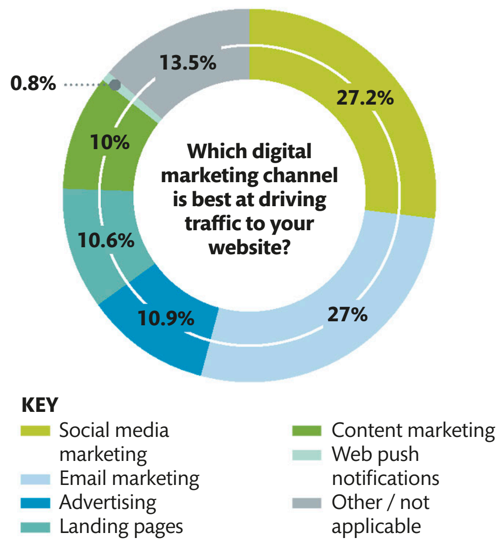
Other forms of digital advertising include mobile advertising, which embeds ads in mobile content viewed on smartphones and tablets or sends text messages; email, which delivers ad copy directly to an email address; and social media advertising, which a company uses to promote products via its social media profile. A major advantage of online advertising is that response rates can be tracked effectively.

94%
of all Facebook's ad revenue comes from mobile advertising.

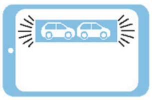
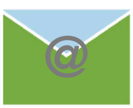
MOST EFFECTIVE ONLINE MARKETING CHANNELS

Which digital marketing method is best for generating sales? In a 2021 global survey by AWeber, marketers placed email at the top, thanks to its potential for personalization and greater engagement.





Online advertising channels

	Pros	Cons
Display advertising 	Attention-grabbing; if ad is clicked on, success can be tracked with pay-per-click system	Internet users suffer ad fatigue and ignore advertisements
Search advertising 	Good for targeting consumers, as search user keywords are matched to advertiser keywords (*see pp.230–231*)	Potentially expensive if using premium keywords; can take time to see results
Mobile 	Cheaper to develop content for mobile devices than for computers; easy to track ad effectiveness	Different screen sizes and systems can distort ad layout; user may feel annoyed by interruption
Email 	Offers opportunity to reach millions of potential customers (*see pp.216–217*)	Recipient may delete email without reading it and is more likely to do so if feeling bombarded; consent normally needed
Social media 	Easy to target specific audience; offers chance of ad going viral and achieving many views (*see pp.228–229*)	Continual posts and updates can easily distract user's attention away from placed ad

19%

of marketing emails are opened on Fridays—the highest "open rate" of the week.

NEED TO KNOW

- **Clickstream** User activity profile that summarizes what an individual has clicked on
- **Behavioral targeting** Process whereby websites capture data from landing page visitors and use it to improve ad effectiveness
- **Interstitials** Ads that precede the content page a user expects to land on or appear right after it

CASE STUDY

Click fraud and botnets

With pay-per-click (PPC) advertising, a business pays a website for every click made on one of its ads, but click fraud has become a serious issue. Fraudsters set up a website, sell PPC advertising, and then infiltrate the computers of unsuspecting users with a computer virus known as a "botnet" to generate fake traffic to the website. Advertisers on the site end up paying the fraudsters for the large number of clicks received. In 2013, one London company uncovered a botnet that was generating nine billion fake clicks per month.

Direct mail

By targeting a large number of potential customers via mail or email, marketers hope to convert some into actual customers. This is achieved through the timing, design, and wording of the message.

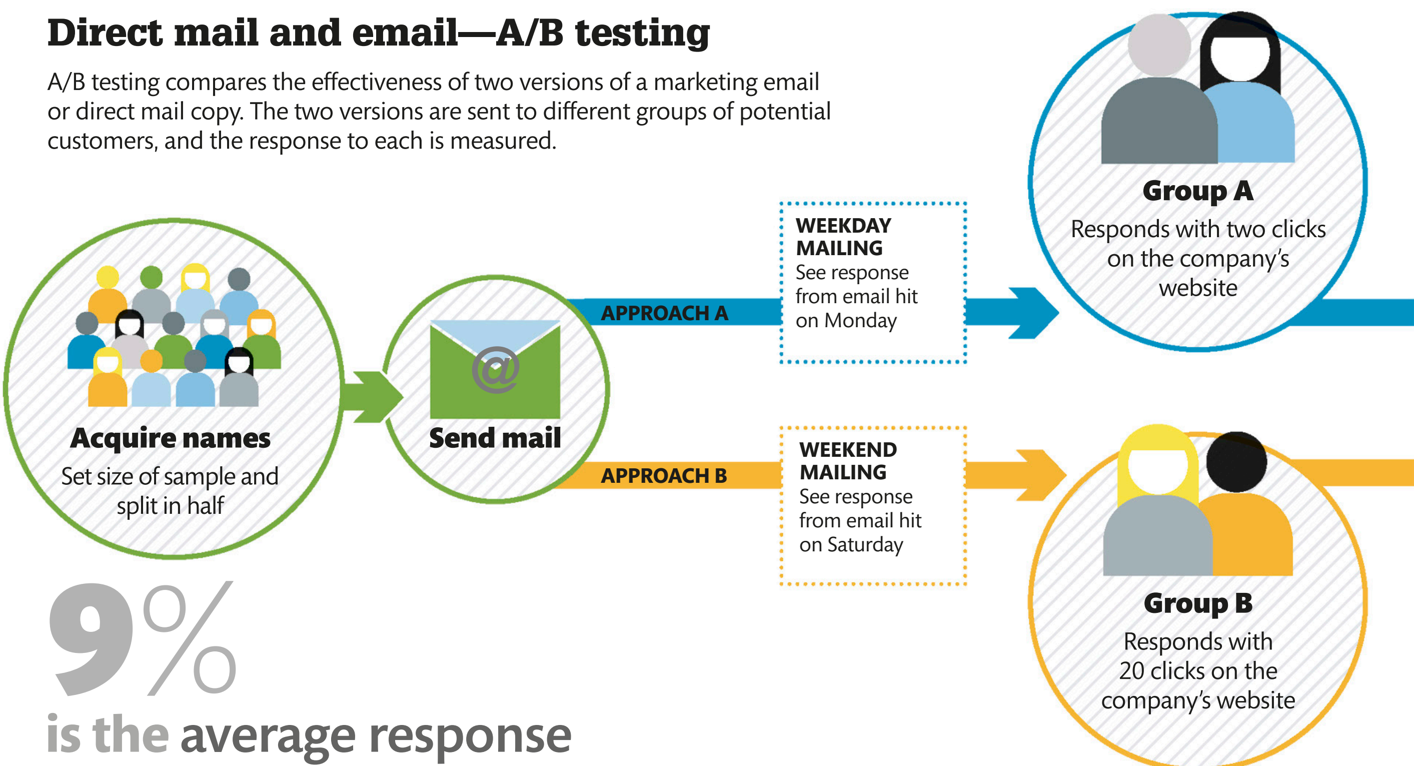
How it works

Direct mail works on the basis of sending a product offer to a large, but targeted, group of potential consumers in the knowledge that at least some of them will take advantage. The more targeted this group is (perhaps by job title, location, or previous purchase), the better the response rate is likely to be.

Direct mail relies on lists of names and addresses, which could be the company's existing clients, people who have previously made inquiries, or a list managed by a specialized agency. It is important to comply with data protection laws governing the use of personal data. In the U.S., there are slightly different rules governing text messages, email, and mail, with rules for postal marketing slightly less restrictive. However, you may not send personally addressed letters to anyone who is on the Mail Preference Service list or who has asked you not to contact them. The most up-to-date rules can be found on the website of the Direct Marketing Association. Marketers are allowed to send direct mail to businesses, though they are advised to keep a list of any that opt out. The percentage of people who respond to direct mail, take the offer, and become customers—a category known as the conversion rate—is extremely low but nevertheless proves to be profitable.

Direct mail and email—A/B testing

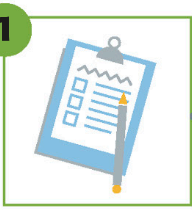
A/B testing compares the effectiveness of two versions of a marketing email or direct mail copy. The two versions are sent to different groups of potential customers, and the response to each is measured.



9%

is the average response rate to direct mail campaigns.

HOW TO SEND DIRECT MAIL

1


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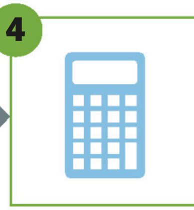

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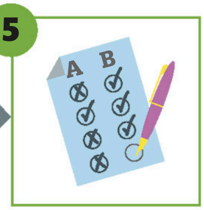


Acquire names
Use own customer contacts or buy a list. Be careful that those listed have given consent.

Prepare direct-mail copy
Write offer/response instructions; include prepaid envelope.

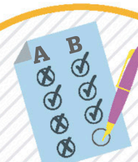
Send letters or emails
Send mail (staggered dispatch controls flow of response).

Determine response rate
Calculate responses as percentage of mail sent out.

Evaluate effectiveness
Assess performance of campaign compared to others.

Data analysis
Comparison of results shows that Saturday time slot is more effective

Campaign B
Send emails to remainder of the group on Saturday



Evaluate effectiveness
Full email blast reveals that approach B yields the best response

NEED TO KNOW

- **Cleaning** Correcting name and address details on traditional mailing lists and email lists to ensure they remain current and effective
- **Print shop** Company that specializes in printing and mailing out letters and catalogs on behalf of a client
- **Merge/purge** Software system that pulls together different mailing lists, searches for duplicates, and makes corrections

Telemarketing

Businesses use telemarketing to initiate direct contact with existing and potential customers. Customers can also contact the company directly. Telemarketing offers businesses a way to retain and acquire customers.

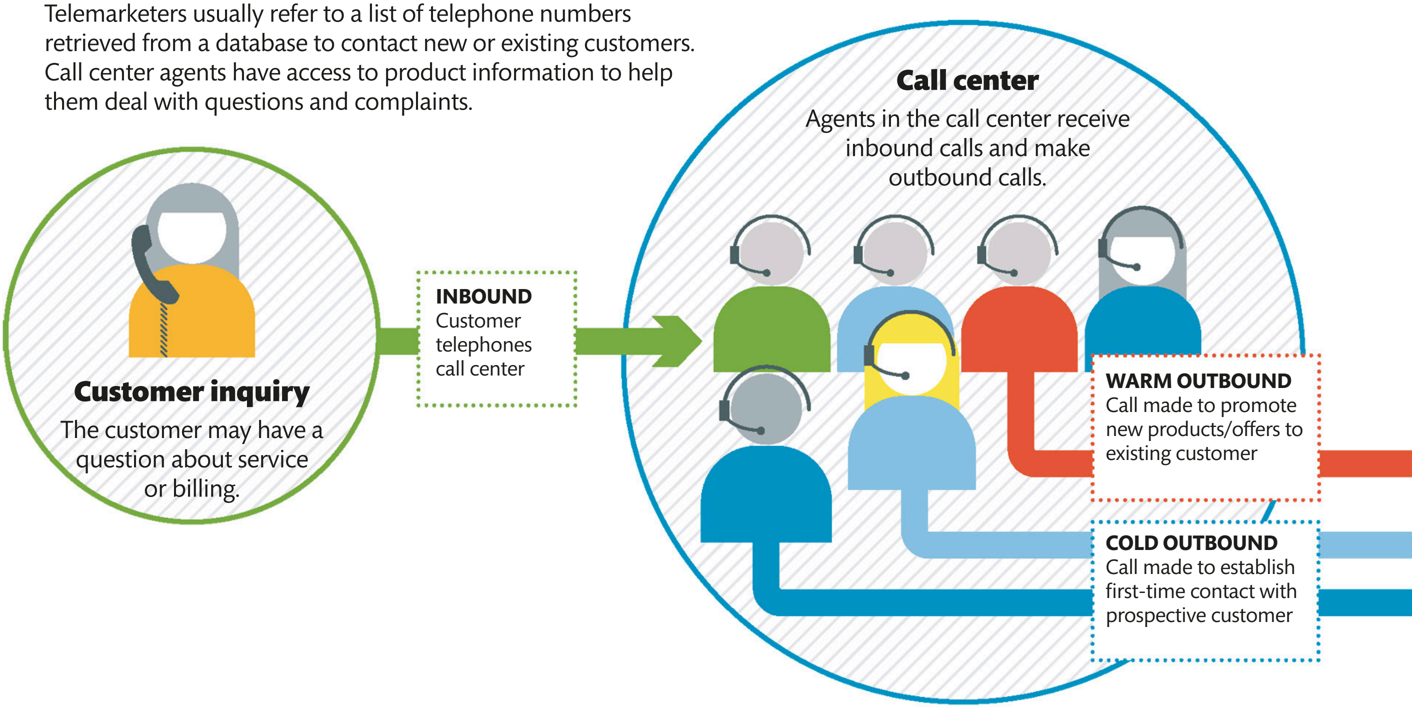
How it works

Telemarketing works in two directions: inbound and outbound. A customer making a call to a business (with a question or complaint, for example) is referred to as an inbound call. It gives the business a chance to retain a customer who may be dissatisfied with a product or service or to win over a new customer contacting it for the first time. When a business makes an outbound call, it is to sell additional products or services to an existing customer or to entice a new customer to make a purchase. Telemarketing sales can be monitored in orders per hour; for example, agent A may make 140 calls per hour and generate $400. A more effective measure is revenue per call—if agent B makes 60 calls per hour but $450 worth of sales, the conversion rate per call is higher for agent B than agent A.

Companies using telemarketing must comply with data protection and other laws. In the US, telemarketers cannot call any individual or organization listed on the Telephone Preference Service (TPS) or the Federal Trade Commission's Do-Not-Call registry—registers of everyone who has opted out of receiving marketing calls. Neither can they call those who have objected to receiving their calls in the past. Some types of products, such as insurance, are not governed by telemarketing rules but by other FTC rules.

Outbound and inbound telemarketing process

Telemarketers usually refer to a list of telephone numbers retrieved from a database to contact new or existing customers. Call center agents have access to product information to help them deal with questions and complaints.

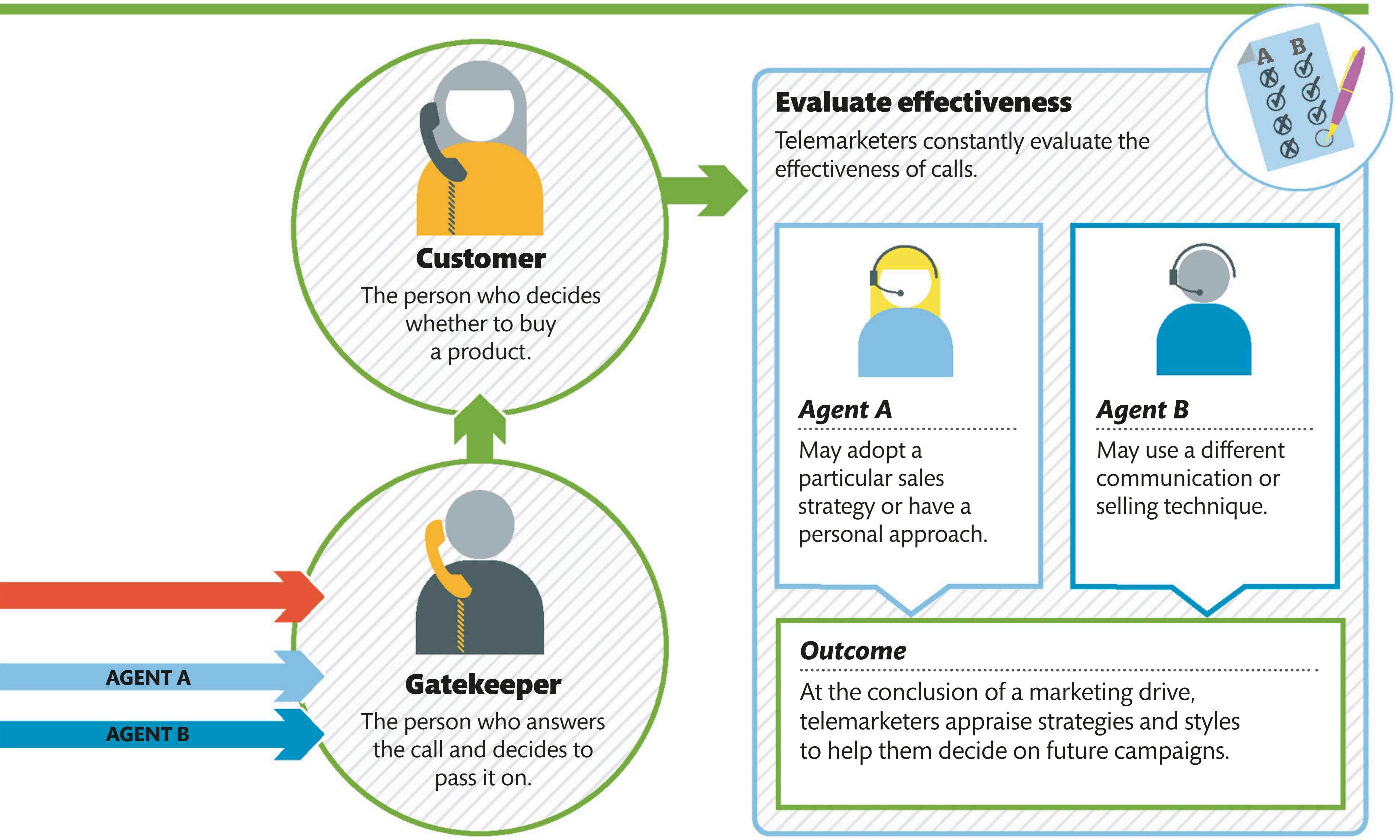


MAJOR CALL CENTER LOCATIONS

The Philippines is one of the top call center locations for US firms. This is because of the high number of Filipinos who have a US education and knowledge of American culture.

NEED TO KNOW

- **After-call work (ACW)** Tasks the agent has to complete after making a call, such as processing sales forms
- **Average handling time (AHT)** Typical length of calls made to customers
- **Automatic call distributor (ACD)** Computerized telephone system that connects each call to the correct agent
- **Average speed of answer (ASA)** Measure of the time it takes to answer inbound calls



Inbound marketing

Inbound marketing lures customers by offering them appealing content and engaging with them. The approach pulls customers into a relationship with a brand rather than "pushing" them into making a purchase, which is how advertising works. Inbound marketing is also known as permission marketing, as potential customers are giving a business permission to communicate with them. In other words, they are actively interacting with the company or brand.

Inbound marketing process

Content forms the core of inbound marketing. It includes text, images, and video that consumers seek out online, especially on social media sites, or in person at events, such as trade fairs, and share with their network of friends, family, and colleagues. Potential customers respond to inbound marketing because the business or brand is offering interesting and relevant information, entertainment, or content with emotional value. Businesses expect this interaction to culminate in a sale or create brand recognition that leads to a sale.

Top types of content marketing

1. Blogs
2. How-to guides
3. Images
4. Infographics
5. Videos
6. Testimonials/reviews
7. Case studies
8. Internet memes
9. Email newsletters
10. E-books
11. Podcasts
12. Twitter chat
13. Newsjacking (giving content to news media)

Exploration

Publish and actively promote content; use search engine optimization (SEO) to attract consumers online.

Decision making

Ensure that content captivates potential customers or solves problems for them; encourage two-way communication.

Purchase

Entice interested site visitors to become customers; make shopping online an easy and positive experience.

Advocacy

Provide excellent customer service; spur customers to make recommendations and share on social media.

NEED TO KNOW

- **Top of funnel marketing (TOFU)** Offers content to grab the initial attention of potential customer
- **Middle of funnel marketing (MOFU)** Offers more detail and encourages participation
- **Bottom of funnel marketing (BOFU)** Attempts to win a sale with low pricing or offers or via customer recommendations

82%

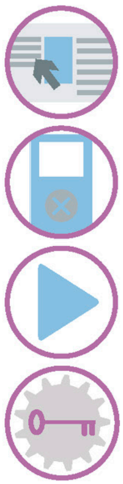
of marketers surveyed in 2021 say they actively use content marketing, up from 70% the year before.

INBOUND MARKETING STRATEGIES

Offline

- **Optimize retail space** Provide a well-designed physical environment that will both draw customers in and encourage them to come back.
- **Engage media** Generate press releases to gain media coverage. Focus on topics of real interest, especially ones that can be backed up by stats and research.
- **Interact face to face** Conduct events in-store that provide a new experience/benefit to customers; hire a stand at a trade event and offer key information.

Online



- **Post blogs** Update company blog with appealing content to attract visitors. *See pp.224–225.*
- **Create podcasts** Produce content relevant to customers searching for information; engage experts to add value. *See pp.226–227.*
- **Produce other content** Post articles, photos, and videos on social media sites; target influencers to encourage viral sharing. *See pp.228–229.*
- **Apply search engine optimization (SEO)** Fill search engine listings with key phrases that answer specific questions; add inbound links from popular sites. *See pp.230–231.*

Outbound vs. inbound marketing

Outbound marketing interrupts consumers to promote a product or brand, but inbound marketing needs consumers' permission—they have to seek out information that leads to the marketing message.

How it works

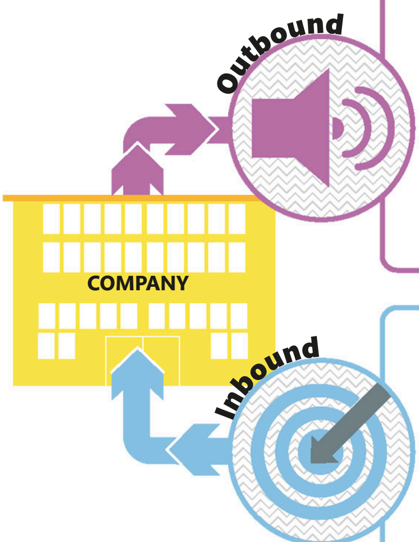
Before the rise of the Internet and the phenomenon of social media, most marketing strategies were outbound. In other words, marketers pushed messages at consumers by interrupting them with advertisements or direct mail. The same principle applies to outbound marketing that appears on the Internet, with pop-up ads interrupting the content the consumer wishes to access. However, because consumers from all over the world now use the Internet to search for information and entertainment, marketers have adopted inbound strategies instead, providing content that draws the consumer to the brand or product rather than pushing marketing messages at them.

NEED TO KNOW

- **Push or interruption-based** Alternative marketing terms used to describe outbound marketing
- **Pull or permission-based** Alternative marketing terms used to describe inbound marketing

Pros and cons

Marketers interrupt consumers with hundreds of outbound marketing messages every day, but they also use subtle inbound marketing tactics to attract consumers. Each strategy has its advantages and drawbacks.



Outbound

Pros

- **Campaign results** can be forecast and measured
- **Marketing material** is easier to create
- **Campaigns** can be tightly controlled

Cons

- **Customer conversion rates** are low
- **Marketing campaigns** are expensive to create
- **Effects** of campaign are often short-lived

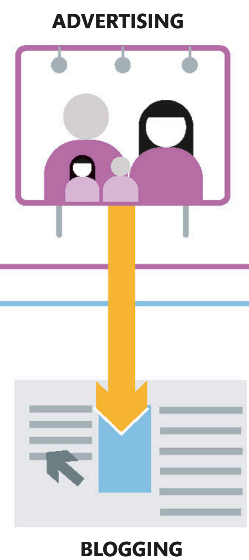
Inbound

Pros

- **More likely** to draw customers with long-term interest in the brand
- **Non-intrusive** approach preferred by customers
- **Cost-effective** compared to outbound campaigns

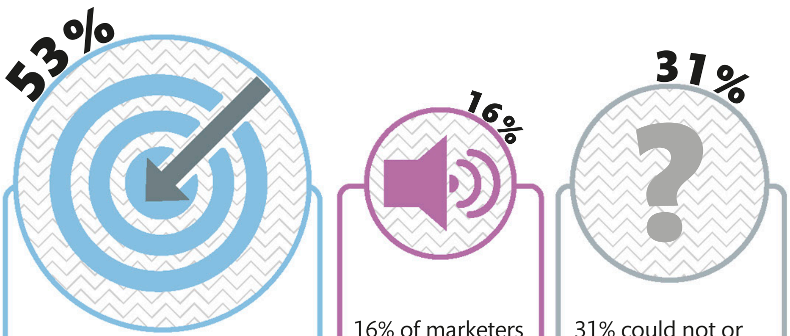
Cons

- **Response** from market may take longer
- **New content** must be generated regularly to keep customers interested
- **Campaign results** can be difficult to measure



ROI: INBOUND VS. OUTBOUND

A report compiled by HubSpot in 2018 said that more than half of marketers find that inbound marketing gives them a higher return on investment (ROI).

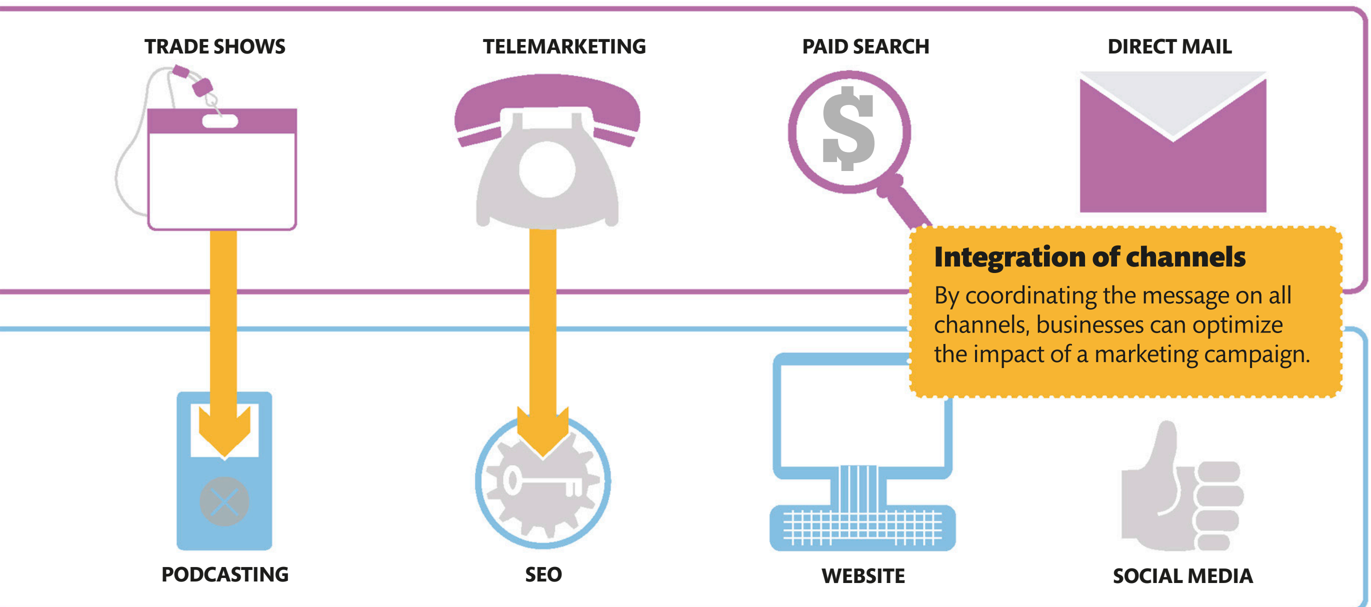


53% of marketers said inbound marketing gives higher ROI

16% of marketers said outbound marketing gives higher ROI

31% could not or do not calculate ROI/do not know/not applicable

74% of marketers say their organizations primarily conduct inbound marketing.



Integration of channels
By coordinating the message on all channels, businesses can optimize the impact of a marketing campaign.

Blogging

Businesses post information articles on web logs, or blogs, as a way to attract consumers to their websites. They may blog on their own website or rely on independent bloggers to achieve this goal.

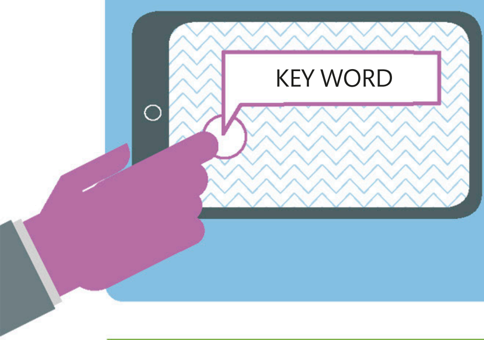
How it works

Unlike a conventional website, a blog is a site that consists purely of informational posts or entries that appear in chronological order, starting with the most recent. Blogs first started appearing in the mid-1990s, when new web tools made it possible for nonexperts to publish material online. This type of web content has since become one of the most common sources of information and opinion on the Internet. Although it was once only individuals who published blogs, many are now commissioned or professionally edited and produced by the company's marketing department.

Blogging process

Marketers may use SEO tools (*see pp.230–231*) to gain insight into what's being talked about online, which helps them determine the most suitable topics for blogs. Many companies have the in-house talent to create blog content.

Select key word or question
Determine key word, phrase, or question that appeals to the target audience.

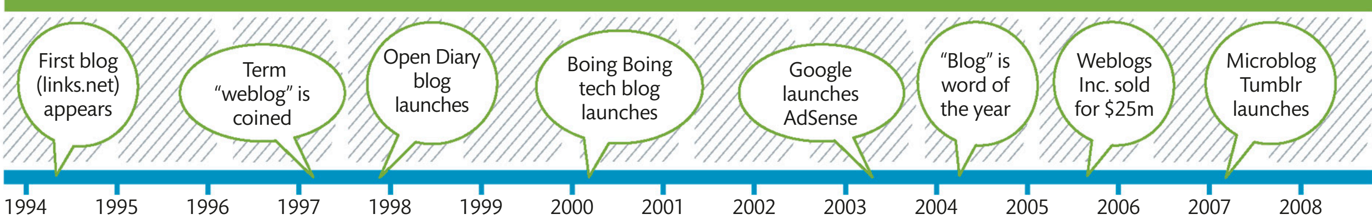


Create content
Base content on key word/question and ensure that it gives readers valuable insight into the chosen topic.

Add links
Cite industry experts and research reports; add photos or videos and provide links to the original sources.

Post
Publish blog entry on Internet by using web software or specialized corporate blogging platforms.

THE RISE OF BLOGGING



40%

of all websites are powered by blogging tool WordPress

NEED TO KNOW

- **Disclosure** Statement of whether blog is sponsored or whether reviewed products are given to blogger or bought independently
- **Splog** Spam blog containing fake articles designed to increase the search-engine rankings of specific websites

Syndicate/share

Submit blog to syndication sites and share with social media networks, such as Facebook, Twitter, Instagram.

Track and measure

Monitor key blog statistics, such as the number of unique visitors and the number who sign up for RSS feed and email.

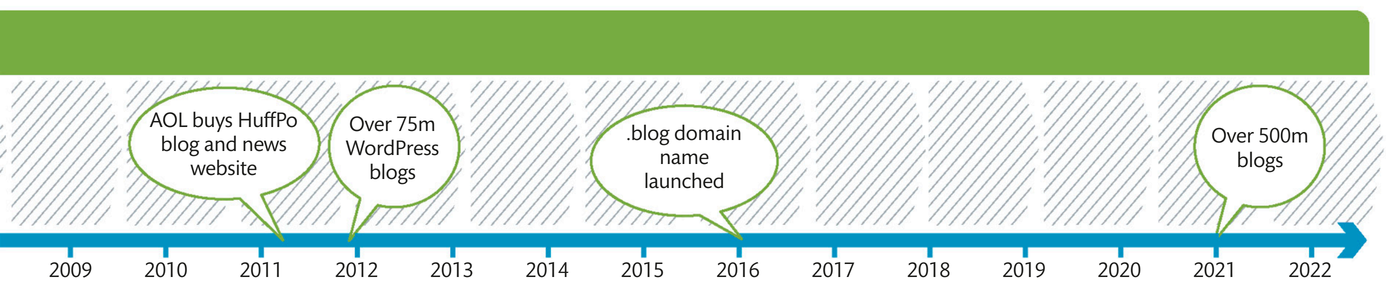
BLOGGING VITAL STATISTICS

Top five statistics to track

- **Number of visitors** Potential customers visiting blog and their route in—via links or direct entry
- **Bounce rate** Share of visitors who leave site after one page
- **Pages per visit** Number of pages viewed by visitor
- **Conversions** Proportion of visitors who subscribe to blog
- **Keywords** Common words visitors use to find blog site

Three blogging mistakes

- **Obsession with SEO** Although SEO is important, focus should be on publishing quality content.
- **Omitting facts** Posts should offer factual information, not just opinion or repackaged content.
- **Lack of legibility** Poorly designed blogs with unclear typography will discourage customers from reading content.



Podcasting/vlogging

Businesses may post audio or video files on the Internet to attract and engage website users; the goal is to convert first-time users into subscribers. Once consumers engage with podcasts or vlogs, companies try to sell products either via advertising on the podcast or its download page or by sponsoring the podcast or vlog to create brand reinforcement.

NEED TO KNOW

- **Podcast** A series of audio or video files that you can download to a personal media player
- **Vlog** A blog in video format, usually recording a person's thoughts or experiences
- **Rich site summary (RSS)** Format used for frequently updating text, audio, and video content online

Podcasting/vlogging process

In order to get commercial results from a podcast or vidcast, a company needs to create and publish interesting and informative content.

Capture content
Decide on topic, create an outline, and then record audio or video material.

Process content
Edit video footage or audio track for background noise, mistakes, repetitions; test and edit further, if necessary.

Select correct format
Save audio in MP3 or AAC format; save video in MP4 format; compress file size for optimal download speed.

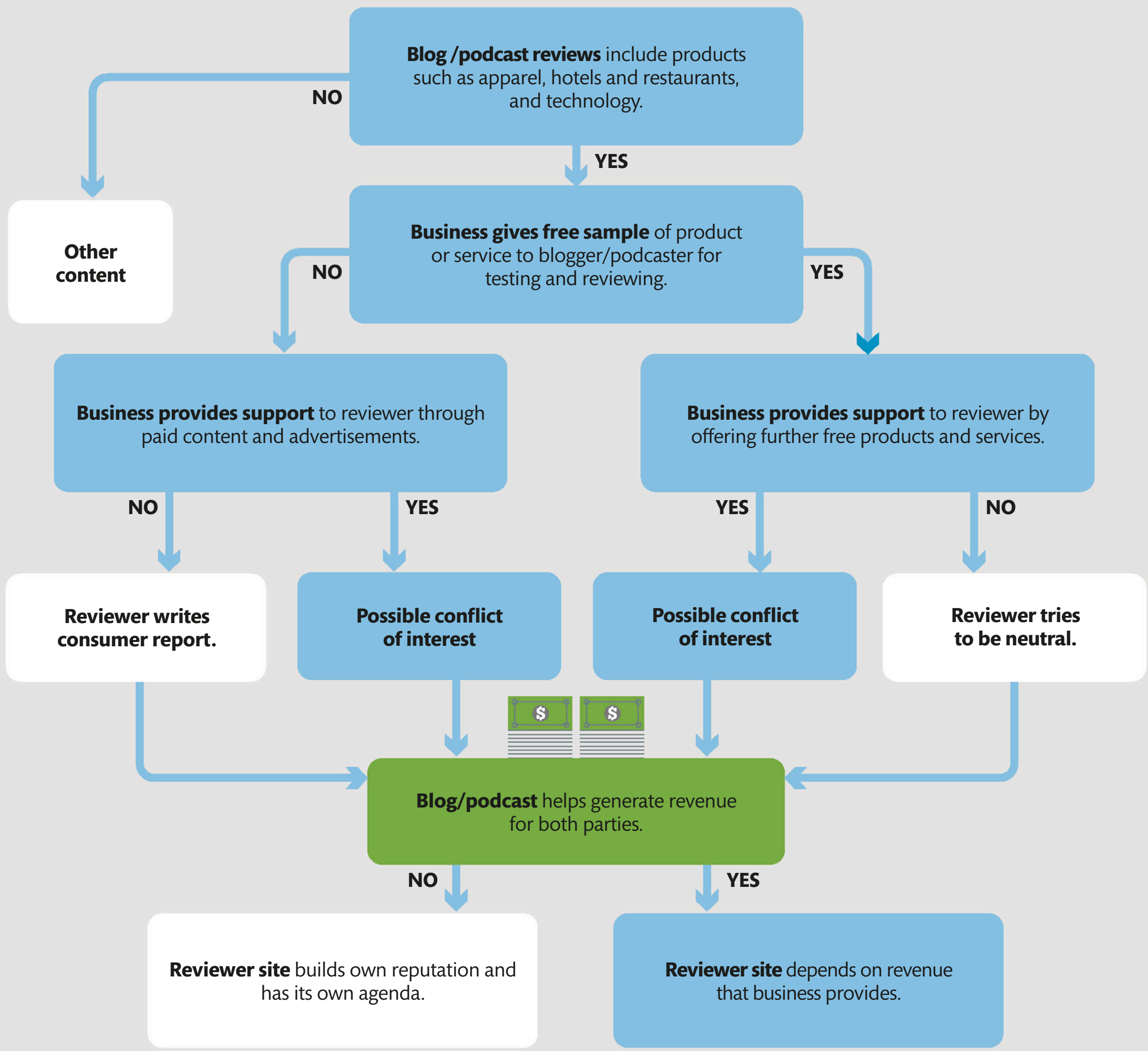
Publish content
Upload file to hosting service, and embed on website. Generate feed address via host or app, and submit to podcast platforms.

Tracking
Count number of subscribers; use web feed services to access user location, level of interaction, and other statistics.

1 billion people listen to podcasts every week

BUSINESS BLOGGING AND PODCASTING ETHICS

Independent online reviewers often collaborate with businesses, which is beneficial to both. Bloggers are required by law to disclose payments or gifts they receive in exchange for creating promotional content, but ethical boundaries can still become blurred.



KEY

- Business potentially influences blogger.
- Blog generates revenue for blogger/business.
- Blogger operates independently of business.

Social media marketing

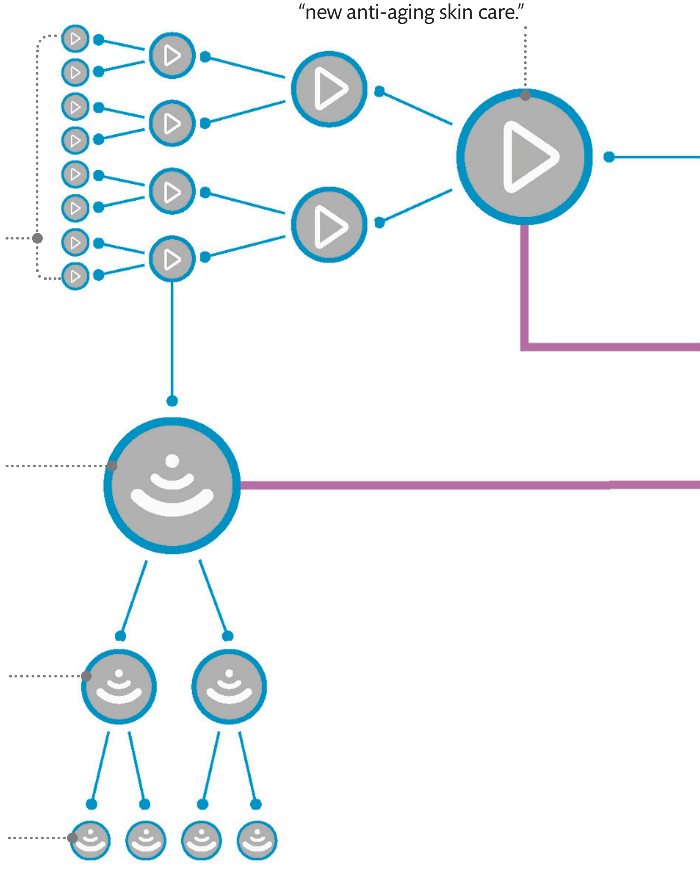
By posting content on social media, marketers try to attract website traffic and draw attention to their products and services. Sometimes, interest in the posted content multiplies rapidly across these channels.

How it works

Social media marketers are responsible for generating engaging content. Typically, the content provides entertainment or offers useful information that social media users actively look for. If the content is compelling enough, it will attract followers, who will share it with their audiences. As the content continues to be shared, liked, and commented upon, it gets picked up by Google and other search engines, helping generate more interest.

Social media marketing in practice

The makers of a new health supplement for repairing sun-damaged skin generate video content showing the dramatic results of the product and launch it across two social media channels. Video footage, an image, or a story that is spread quickly and widely via the Internet is said to have gone viral.



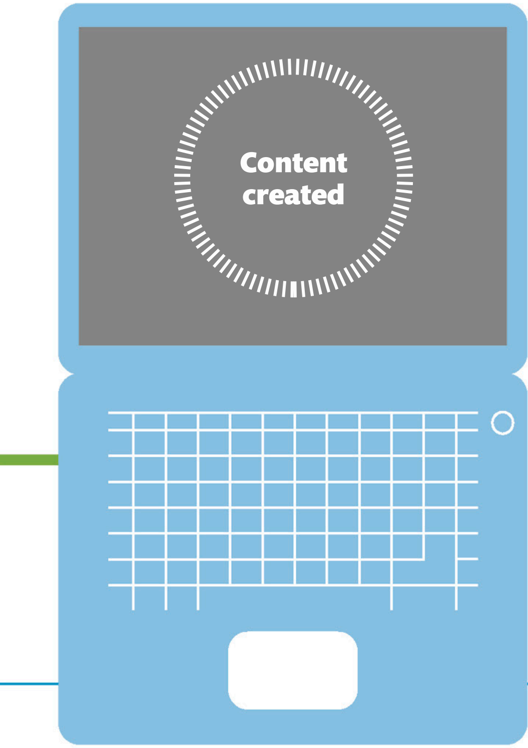
FROM SEARCHERS TO SUBSCRIBERS

One key aim of content marketers is to convert people who have arrived on a website, blog, or social media page into engaged consumers, who subscribe and allow two-way communication.

Stage 1 Marketers post content, such as a video, article, or special offer, to draw in consumers.

Stage 2 They rely on social media users to share content with their friends and spread their post to a wider audience.

Stage 3 They monitor response rates from consumers and audit their posts.

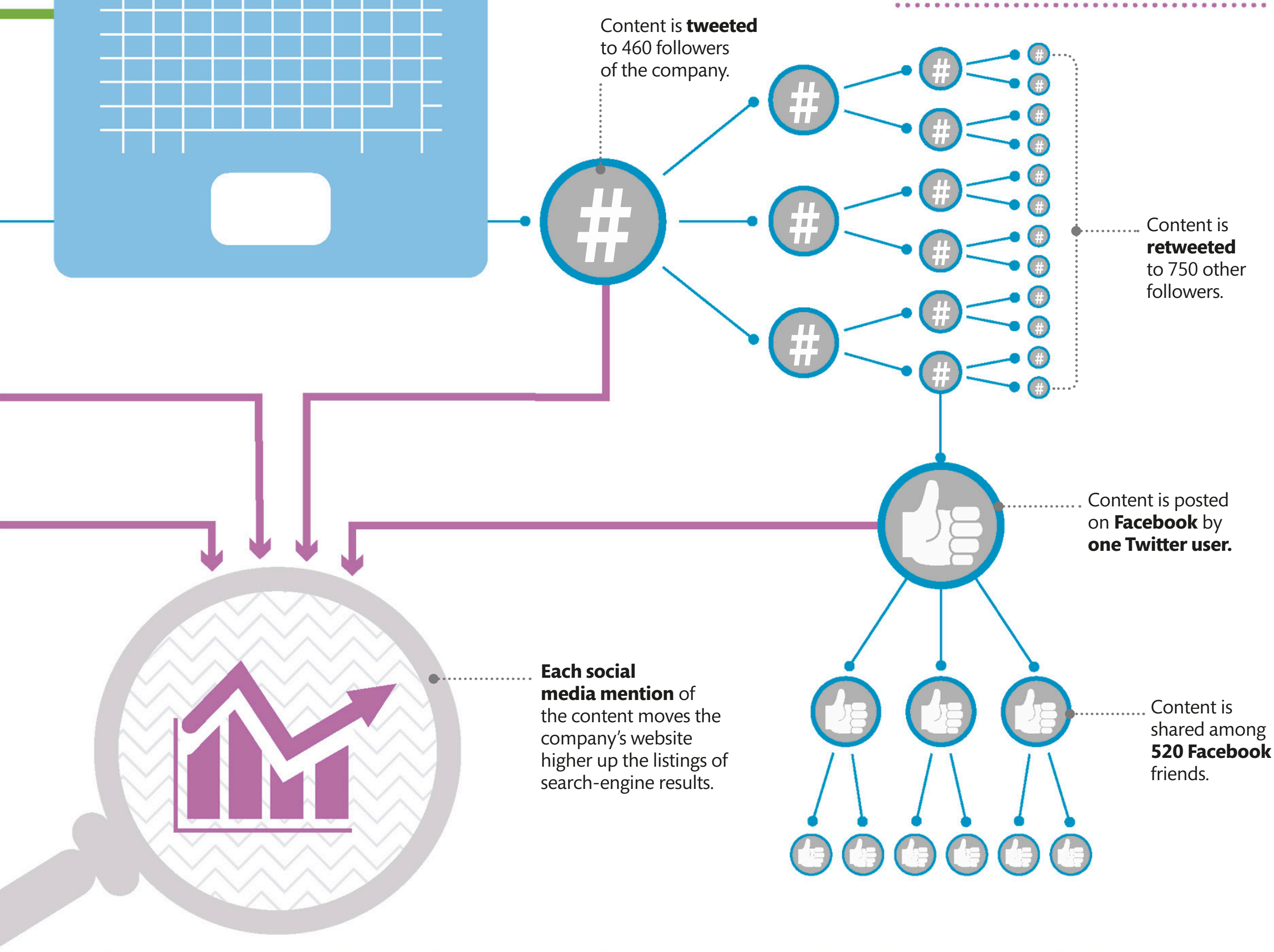


90%

of marketers say social media data helps them stand out from peers.

NEED TO KNOW

- **Social graph** Internet graph that maps connections between user groups, such as Facebook friends
- **Social media optimization (SMO)** Use of online communities to maximize social media coverage of product or event
- **Social media monitoring** Process of tracking the number of mentions a brand or company receives on social media sites



Search engine optimization (SEO)

SEO is a process marketers use to acquire traffic from search results on search-engine sites. SEO software tools are available to help the user create Web pages that will appear at the top of search-engine listings.

How it works

Companies that have a Web presence must ensure that their website has a high ranking on search-engine listings. To achieve this, they frequently use SEO tools to monitor where their website appears when keywords are searched for and take steps to keep it moving up the search results page. Some of the important measures marketers take include coming up with the right keywords, linking to other websites, and generating content that includes frequently searched keywords or phrases so that their website remains relevant to a wide variety of search queries.

Search engines offer pay-per-click, a service that places a company's listing at the top of a search results page. Every click generates a fee payable to the search engine.

32% of people click on the top Google search result.

SEO process

These tools can be used regularly in a continuous attempt to move a website higher up the listings.

Keyword research

Use SEO tools to research the most popular keywords.

- **Brainstorm keywords**
- **Use tools to expand list**
- **Think of how users will search**

Optimize pages

Create pages with the right elements to rank high.

- **Create similar content to top-ranked pages for keywords**
- **Write compelling title tags**
- **Use descriptive URLs, image tags, and file names**

Structure and technical SEO

Help search engines find, crawl, and index your site.

- **Use logical site structure**
- **Ensure site is mobile-friendly and fast to load**
- **Make site secure with HTTPS**

Keyword selection

Use intuition and analysis with SEO tools to narrow your list.

- **Analyze traffic for keywords**
- **See how difficult it is to rank for each keyword**
- **Decide how best to compete**

NEED TO KNOW

- **Robot.txt** Text file that stops Web crawler software, such as Googlebot, from crawling certain Web pages
- **Search algorithm** Step-by-step calculation that looks for clues to decide on search rankings
- **Metadata** Information that describes stored data—data about data
- **Black hat SEO** Frowned-upon SEO practices—such as stuffing in too many keywords—that go against search-engine guidelines
- **Bounce rate** The proportion of visitors who leave a website after viewing only one page

SEO TIPS

Avoid single words because multiple-word phrases rank higher.

Monitor search statistics using Google Keyword Planner or Semrush.

Add blog to offer content that search engines will pick up.

Prioritize good content and update it regularly with keywords.

Use reputable sites with relevant content to link back to your site.

Give headings keywords that relate to content on page.

Reporting and tracking

Use tools to track traffic and report on website ranking.

- **Focus on quality of visits**
- **Check server reports**
- **Tally sales from searches**

Link-building

Add links from related websites to point back to own site.

- **Link to high-profile sites**
- **Contribute to social media**
- **Ask partners to link**
- **Mimic rivals' Web links**

SEO spider

Software that crawls the Internet, adding content to search-engine databases

Keyword revision

Monitor search results from current keyword selection and make adjustments.

- **Make sure terms aren't broad**
- **Avoid specialized words**
- **Alter word order**

Business development

The overall goal of sales and marketing teams is to generate customer contact and convert it into revenue. This is the core of business development, and it involves a continual process of drawing in potential customers, enticing them to purchase, and keeping them engaged. During this process, marketers and sales people use a range of strategies and channels to attract customers and to earn their long-term commitment to a brand and product.

Collaborative process

Marketing departments generate brand identity, while sales teams do the selling. Working together, they aim to take potential customers on a journey from brand awareness to repeat sales, communicating the message through various channels.

Build brand awareness

Target customer groups with content and/or ad campaigns to inform them about the brand and its values. This will lay the foundation for a long-term relationship. *See pp.234-235*.

Advertising

Public relations

Generate leads

Use a combination of inbound and outbound marketing strategies to entice potential customers to seek out the brand or product. *See pp.236-237*.

Social media

Live events

Convert leads into sales

Once potential customers are interested, entice them to buy with targeted messages, offers, and well-designed e-commerce sites. *See pp.238-239*.

Face-to-face communication

Email lists

Telemarketing

63%

of companies do not have a structured approach to optimizing their business.

BUSINESS DEVELOPMENT STRATEGIES

Business development is reliant on growth. Sales and marketing teams can increase long-term profitability by building up a customer base and then trying to retain it. There are several ways to ensure that the customer base remains buoyant.

- **Chart customer journey** from before to after sale.
- **Think of ways to reduce cost of sale** and increase customer satisfaction.
- **Integrate sales processes** with marketing to gain and retain customers; think about ideal customer.
- **Monitor and evaluate** these processes regularly.

Loyalty programs

Call center

Analytics tools

Know-how

Databases

Retain customers

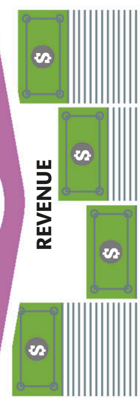
Follow up sales with efficient delivery, excellent customer service, and personal contact to reinforce positive customer relationships.
See pp.240-241.

Review effectiveness

Track marketing spend on each channel and analyze results to gauge return on marketing investment (ROMI).
See pp.242-243.

Develop intellectual capital

Nurture talent and foster creativity in order to optimize ongoing marketing efforts.
See pp.244-245.



Special offers and updates

Return on investment (ROI)

Traffic driving to website

Innovation

Branding and rebranding

A brand is defined by the characteristics that mark a particular product. Branding is used to communicate a product's qualities to a consumer and create a lasting bond between supplier and customer.

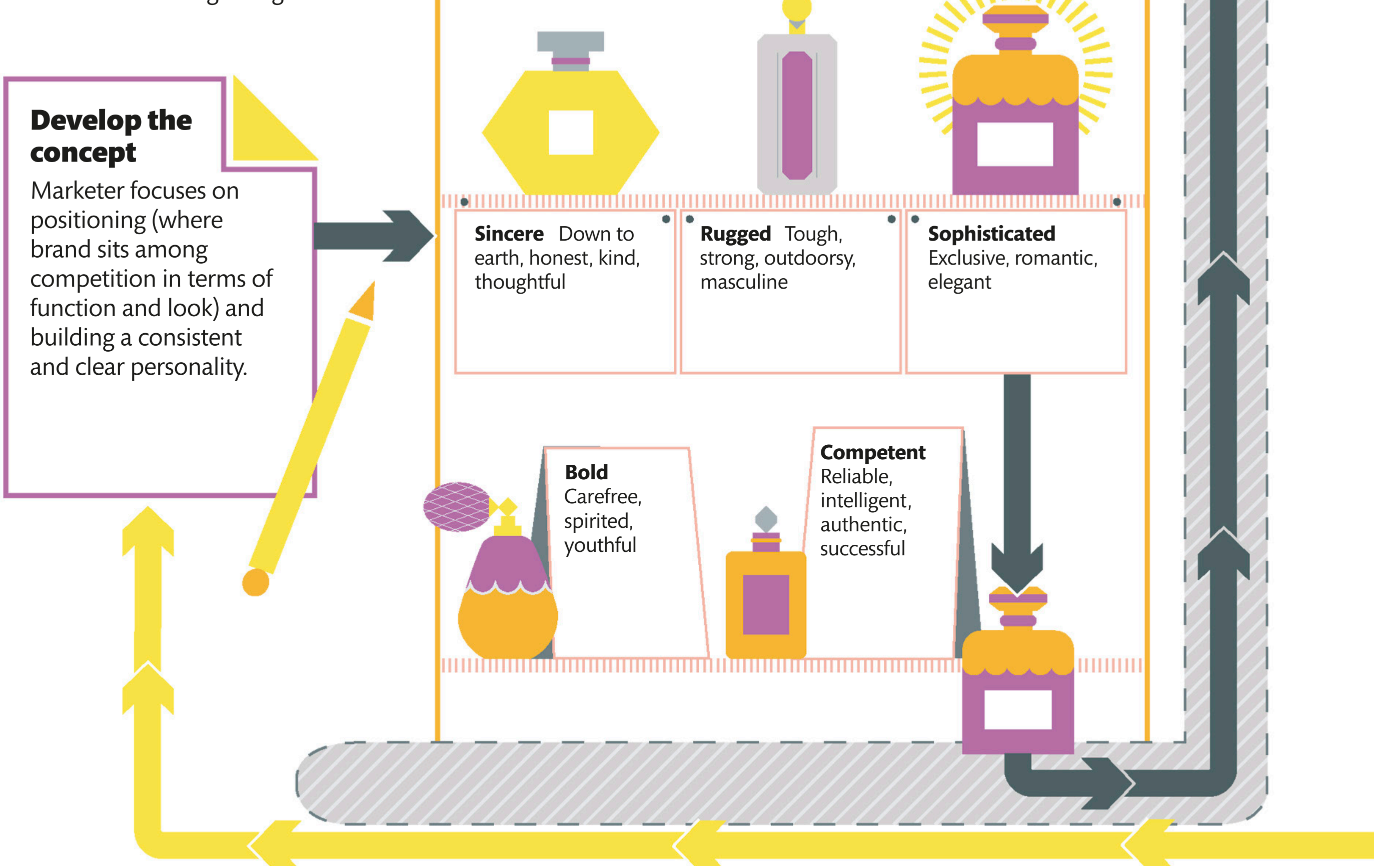
How it works

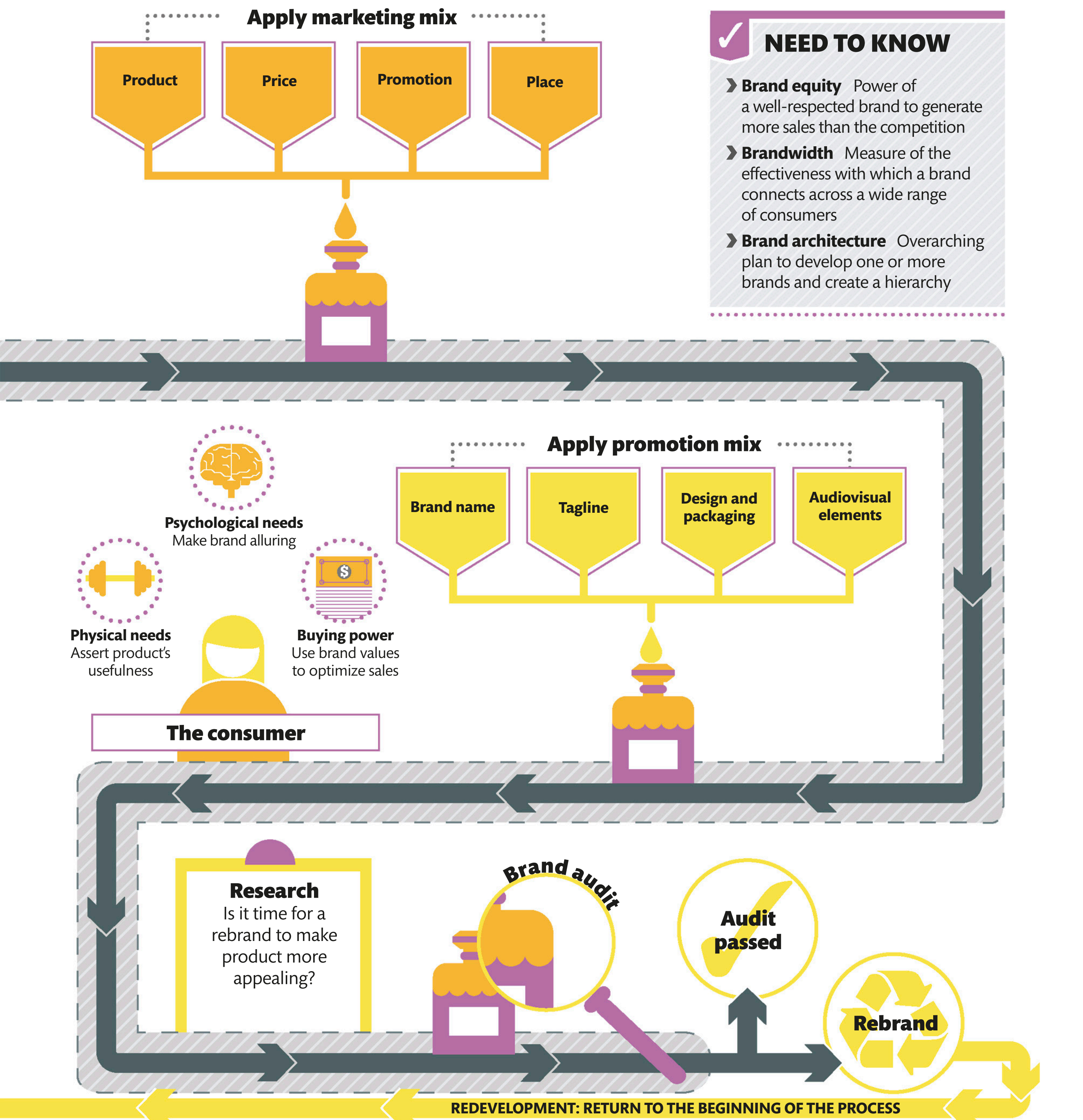
When a supplier develops a brand, it creates a defined set of values, expressed in product imagery, colors, logo, slogan, jingles, promotional imagery, and how employees relate to customers and suppliers.

The brand works for both the supplier and the customer, aiming to eliminate uncertainty and risk and to convey key attributes. Social media helps promote brands—for example, 90 percent of Instagram users follow a brand.

The branding cycle

There are typical stages to branding a product. In order to rebrand (redevelop) a product, the supplier starts over at the beginning.





NEED TO KNOW

- **Brand equity** Power of a well-respected brand to generate more sales than the competition
- **Brandwidth** Measure of the effectiveness with which a brand connects across a wide range of consumers
- **Brand architecture** Overarching plan to develop one or more brands and create a hierarchy

Lead generation

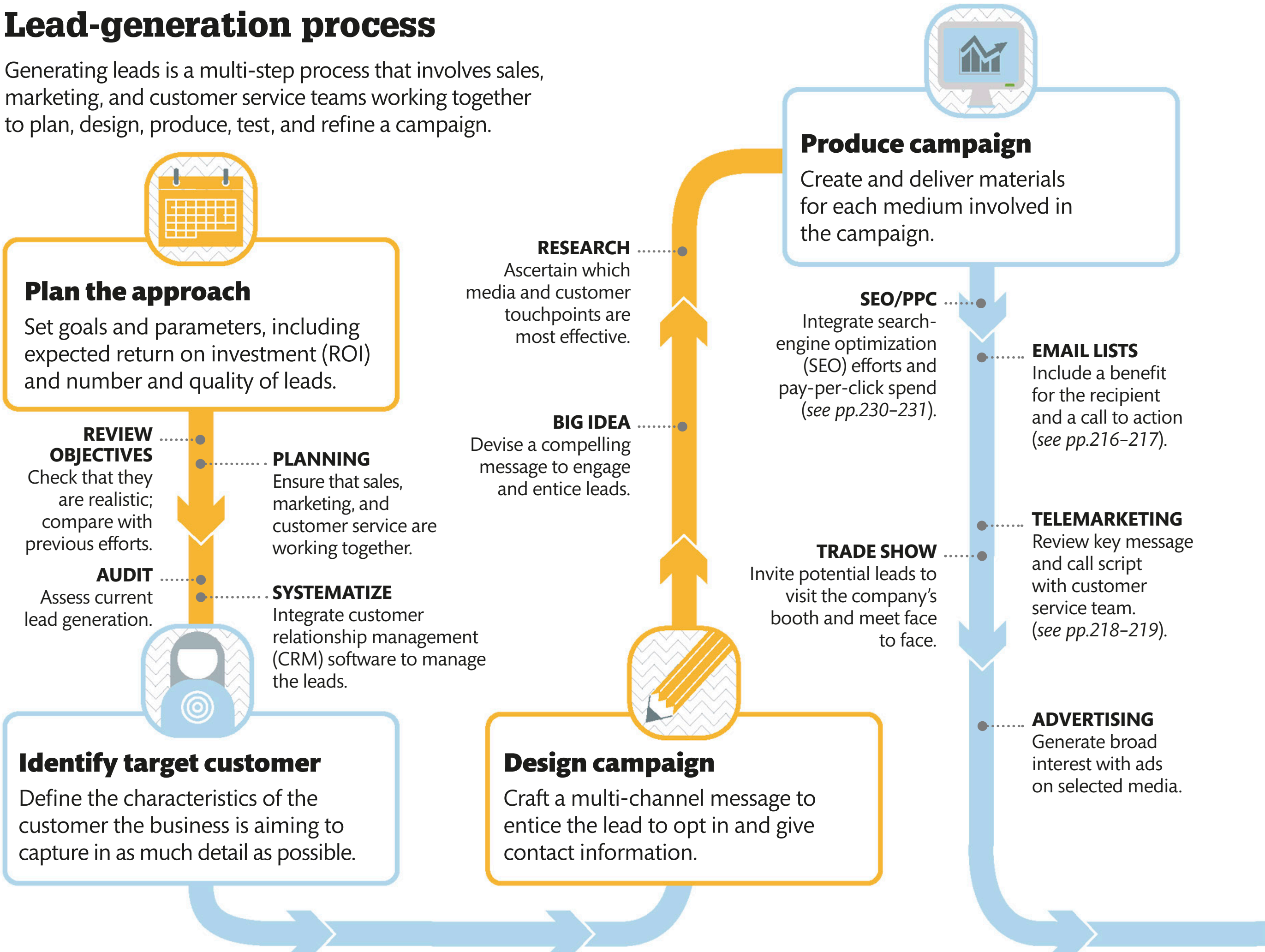
For a business to grow, one of its basic goals is to acquire new customers. Lead generation is the strategy it uses to locate, target, and nurture leads (potential customers).

How it works

The purpose of generating leads is to find consumers who may need or want to buy the product a business is selling. Sales teams do not want to waste resources on people who have no interest in the product in the first place, so the process of lead generation helps define and capture the potential customers who seem most inclined to become actual customers—known as high-quality leads. To generate leads, marketing and sales departments typically collaborate on a campaign, offline or online, designed to identify and recruit promising customer prospects. Acquiring contact information is the first part of the process. Converting leads into sales is the next step (*see pp.238–239*).

Lead-generation process

Generating leads is a multi-step process that involves sales, marketing, and customer service teams working together to plan, design, produce, test, and refine a campaign.



TOP FIVE STRATEGIES FOR LEAD GENERATION

- **Create content** such as a viral video or a newsworthy business report that takes leads to a sign-up page.
- **Use both online and offline channels**, as most customers will respond to just one channel.
- **Trace the customer touchpoint**– the point at which a customer comes into contact with the product– before, during, and after purchase. Touchpoints may range from online reviews to billing.
- **Tailor the call to action** to the channel, such as inviting trade show visitors to enter a competition.
- **Design effective opt-in web forms** to capture data, such as asking customers to sign up for updates.

NEED TO KNOW

- **Owned media** Channel owned by a business, such as a website, blog, or social media profile
- **Attention, interest, desire, action (AIDA)** Model for effective marketing messages
- **Cost per lead (CPL)** Amount it costs the company to acquire one potential customer

RESPONSE RATES
Tally how many leads have been generated so far.

QUALIFIED LEADS
Determine percentage of initial contacts with purchase capability.

ONLINE CONVERSION RATES
Calculate percentage of Web visitors converted to leads.

ANALYZE PERFORMANCE
Identify adjustments needed to keep campaign on track.

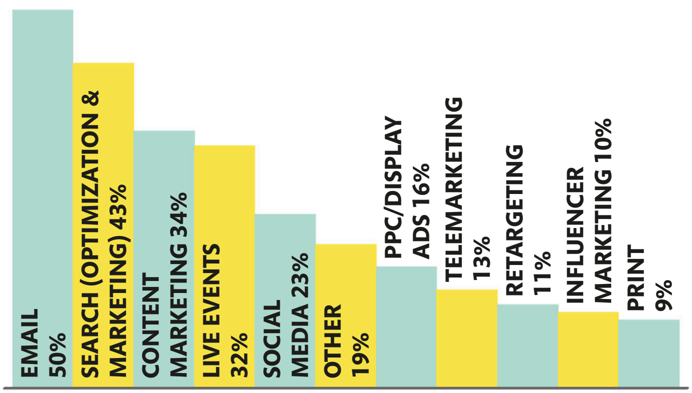
Refine
Fine-tune the filtering process to ensure that leads being generated are high quality and likely to buy.

Measure
Track and measure the response from the various campaign activities to gauge effectiveness.

Test campaign
Monitor the initial hours and days of the campaign and make any corrections that are needed.

B2B LEAD GENERATION

Most businesses selling to other businesses (B2B) identify lead generation as one of their most important digital marketing priorities. But which tactics do they find most effective?



% of B2B firms that place tactic in top three for generating leads with the highest return on investment in 2020

Lead conversion

The process of turning a customer's interest into a sale is called lead conversion. The task requires not only a sales pitch to promote the product or service but also an approach tailored to the customer.

How it works

Sales and marketing departments are responsible for generating sales income for a company. The first step is to locate or identify potential customers—lead generation. The second step is to make contact with those potential customers and entice or persuade them to buy—lead conversion.

A sales pitch is used to convert leads into customers. However, nowadays, the stereotypical spiel delivered by an overzealous salesperson has been largely replaced by more sophisticated tactics, such as live chats on shopping websites, which inform customers and invite them to participate in a dialogue rather than simply pestering them.

Raw lead
Potential customers, perhaps a website visitor or a person encountered at a live event

?

Pitch Find precise needs of suspect; show product's qualities and unique values to counter objections.

50/50

Prospect
One step away from becoming a customer, prospects need a final enticement to convince them to buy the product.

Pitch Reinforce product's value to prospect; offer payment options; highlight customer satisfaction policy.

Pitch Suggest keeping in touch (with their consent) with updates, offers, product add-ons, or discounts.

Customer
Raw lead has committed to buy; focus is now on retaining the customer and enticing them to make repeat purchases.

NEED TO KNOW

- **Lead scoring** System used to measure the readiness of leads for conversion
- **Sales pipeline** Visual tracking of the number of leads, suspects, and prospects at each stage in order to monitor sales process
- **Lead nurturing** Informal contact with a lead designed to gradually win them over as a customer
- **Cost per touch** Measurement of the cost of sales labor each time a lead is "touched" (contacted)

2.27%
the average lead conversion rate via e-commerce sites in 2021

Pitch Involve raw lead in website experience or conversation; identify need for product; show benefits.

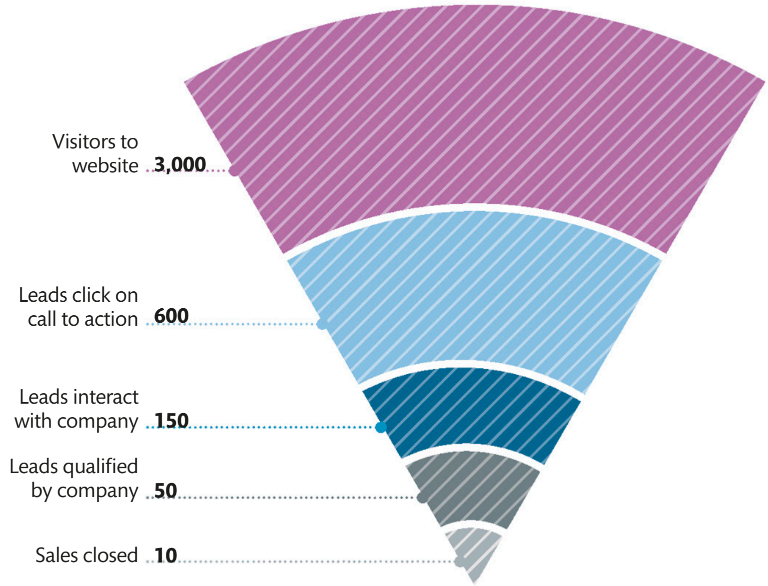
Suspect
Raw leads show their interest by remaining on website or by not ending conversation with company representative.

Inactive
Prospect isn't ready to buy immediately but shows enough interest to suggest they might buy in the future.

Dead lead
Lead will not convert but may be worth trying to revive in future.

Online lead conversion

A strategy is required for steering website visitors through every step of the lead-converting process. It is often presented as a funnel. Once visitors have arrived at a website, they are enticed to click on a "call to action" (CTA) button, which takes them farther into the funnel.



THREE CLASSIC SALES PITCHES

High concept
Catchy introduction that captures the vision or key idea of a product or business; intended to grab attention and interest

Elevator
Short summary (under a minute long) that explains the why, what, and how of a business or product

20-minute deck
Presentation that explains the product or business in detail and how it can serve the need a prospective customer may have

Customer retention

Existing customers help businesses generate the majority of profit and growth through making additional sales and referrals, and so retaining these customers is a high priority for marketers.

Measure customer retention level

Track how many customers repeat purchase or buy more products.

Identify satisfied customers

Customer referral

Measure the number of referrals an individual customer generates.

Loyalty

Pinpoint customers who are active in the brand's loyalty program.

Identify the dissatisfied

Defection

Find out why certain customers have left and which competitor they have gone to.

Complaint analysis

Examine written customer complaints and call-center records.

Introduce retention improvement strategy

Early warning systems

Anticipate any problems and alert customers in advance.

Recovery programs

Apologize for any mistakes and make amends to woo dissatisfied customers back.

Customer feed-back surveys

Listen to customers and identify people at risk of defecting.

Loyalty programs

Reward customers with improved incentives for staying loyal.

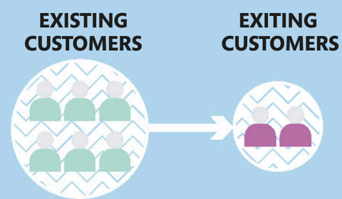
Boost customer service

Offer employees incentives to build customer relations.

Monitor and measure by analyzing

Customer satisfaction

Assess rate of customer complaints and recommendations.



Attrition rate

Calculate the number of customers retained (existing), lost (exiting), or gained in a given period.

Revenue targets

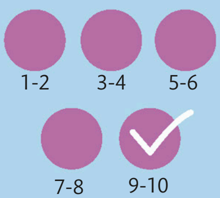
Measure revenue targets against cost of customer retention efforts.

How it works

There are two stages to the process of customer retention: measuring the current rate of retention and applying strategies to manage and improve it. Practices include identifying the most valuable customers and nurturing relationships with them. The least valuable or most costly customers may be dropped if they show little development potential.

Upsell and cross-sell leads

Identify customers who may buy larger products or related items.



Net promoter score®

Use management tool to gauge how likely a customer is to recommend company to others.

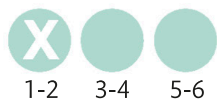
Customer retention savings

Calculate savings made in marketing spend by retaining existing customers.

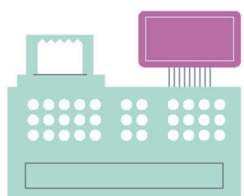
TOP FIVE REASONS FOR LOSING A CUSTOMER

Senses indifference from provider

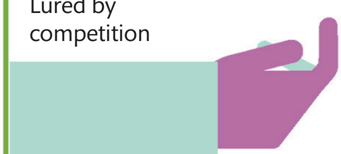
Dissatisfied with product or service



Unhappy with price



Lured by competition



Natural attrition (death, relocation)

NEED TO KNOW

- **Customer lifetime value (CLV)** Measure of the amount customer will contribute to company revenue in the long term
- **Customer retention rate (CRR)** The number of customers retained over a given period, expressed as a percentage
- **Customer acquisition cost (CAC)** The amount company spends to gain a customer; also called cost of customer acquisition (COCA)

82% of firms agree that customer retention is cheaper than acquisition—but most focus more on the latter.

Return on marketing investment (ROMI)

Many organizations gauge the effectiveness of the amount they spend on marketing campaigns by measuring the return they make on marketing investment, which is commonly known as ROMI.

How it works

A subset of ROI (return on investment), ROMI is one of the key calculations businesses use to determine the effectiveness of the money they spend on marketing.

ROMI is measured by comparing the revenue gained against the investment made in marketing and is used to assess online campaigns, in particular. This calculation, however, only reflects the direct impact of marketing investment on a business's revenue and fails to take into account other gains, such as the word-of-mouth effect on social media, which is more difficult to quantify than the more clear-cut response received from advertising or direct mail.

As a result, many digital marketers now factor lag time or brand awareness into their ROMI calculations in order to quantify less tangible benefits and target future campaigns more effectively.

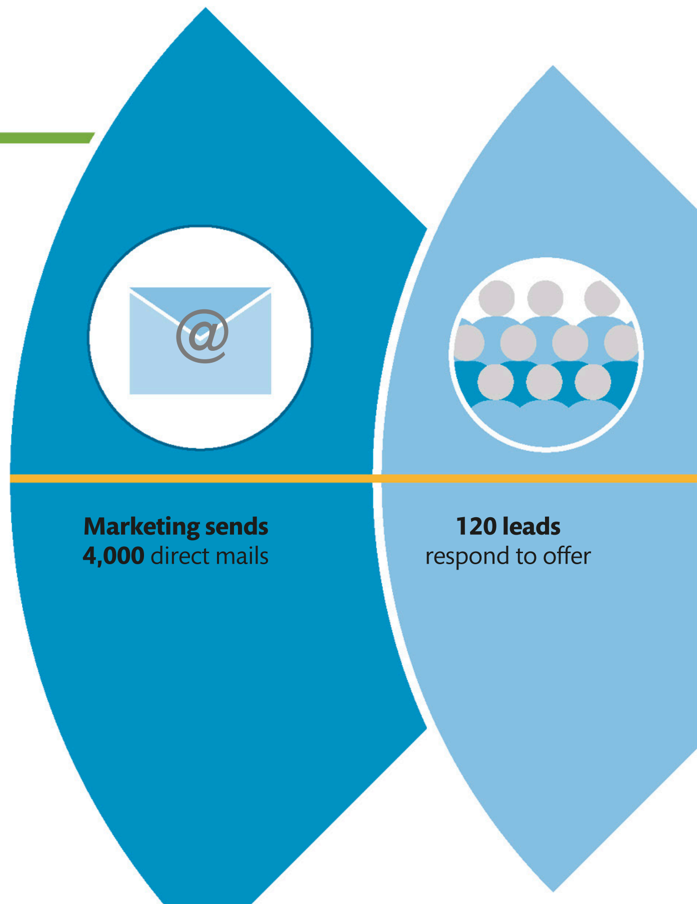
NEED TO KNOW

- **4P3C1E framework** Method that uses several variables to calculate effectiveness of marketing campaign
- **Success metrics** Use of standard measure (metric) to help manage marketing process and to assess its performance

ROMI in practice

The diagram shows how a commercial air-conditioning company might use ROMI to measure the performance of a marketing campaign. The company spends $2,100 on a direct-mail promotion, which it aims at offices in three major cities to generate sales leads and secure new contracts. The direct-mail brochure contains a contact form offering a 10 percent discount to new clients who respond to the promotion within a specified period of time.

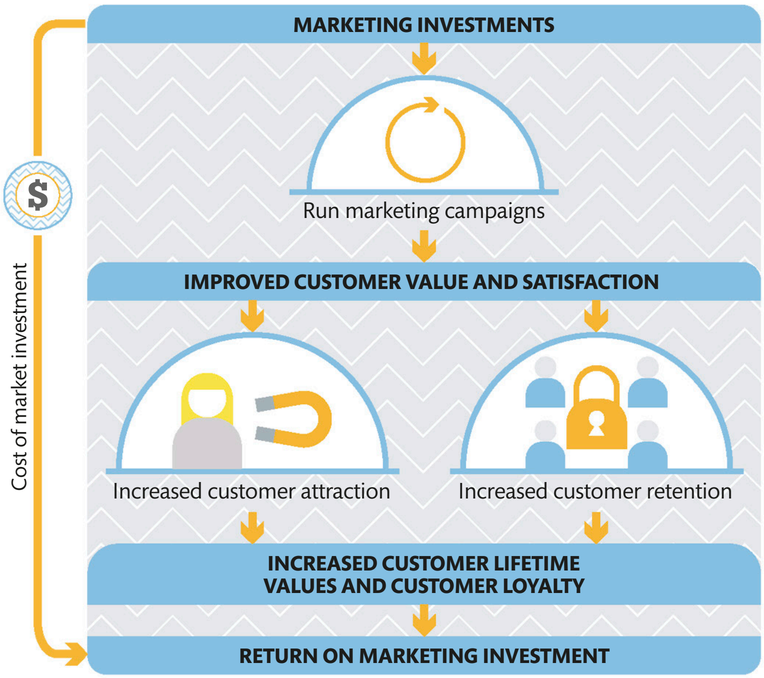
$$\frac{\text{GROSS PROFIT} - \text{MARKETING INVESTMENT}}{\text{MARKETING INVESTMENT}} = \text{ROMI}$$

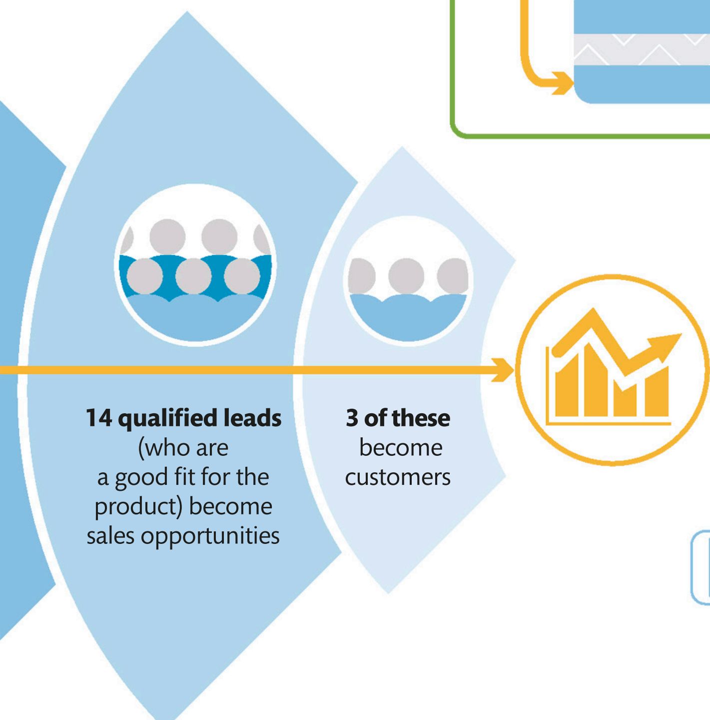


$36 is generated for every $1 spent on email marketing

LONG-TERM BENEFITS OF MARKETING INVESTMENT

Some aspects of marketing investment are difficult to measure immediately. The benefits of providing excellent customer service, for example, or investing in research to help marketers retain customers may not be evident right away but will reap long-term profits.





Results

Total new customers = 3
Average customer spend = $6,500 (after 10% discount deducted from average $7,222 total spend)
Revenue from marketing = $19,500 (3 x $6,500)
Campaign spend = $2,100 + $2,167 (3 x $722) cost to company of promotional discount = $4,267 total
ROMI = $4.57 per customer / per $ spent on campaign

$$\frac{\$19{,}500}{\$4{,}267} = \$4.57$$

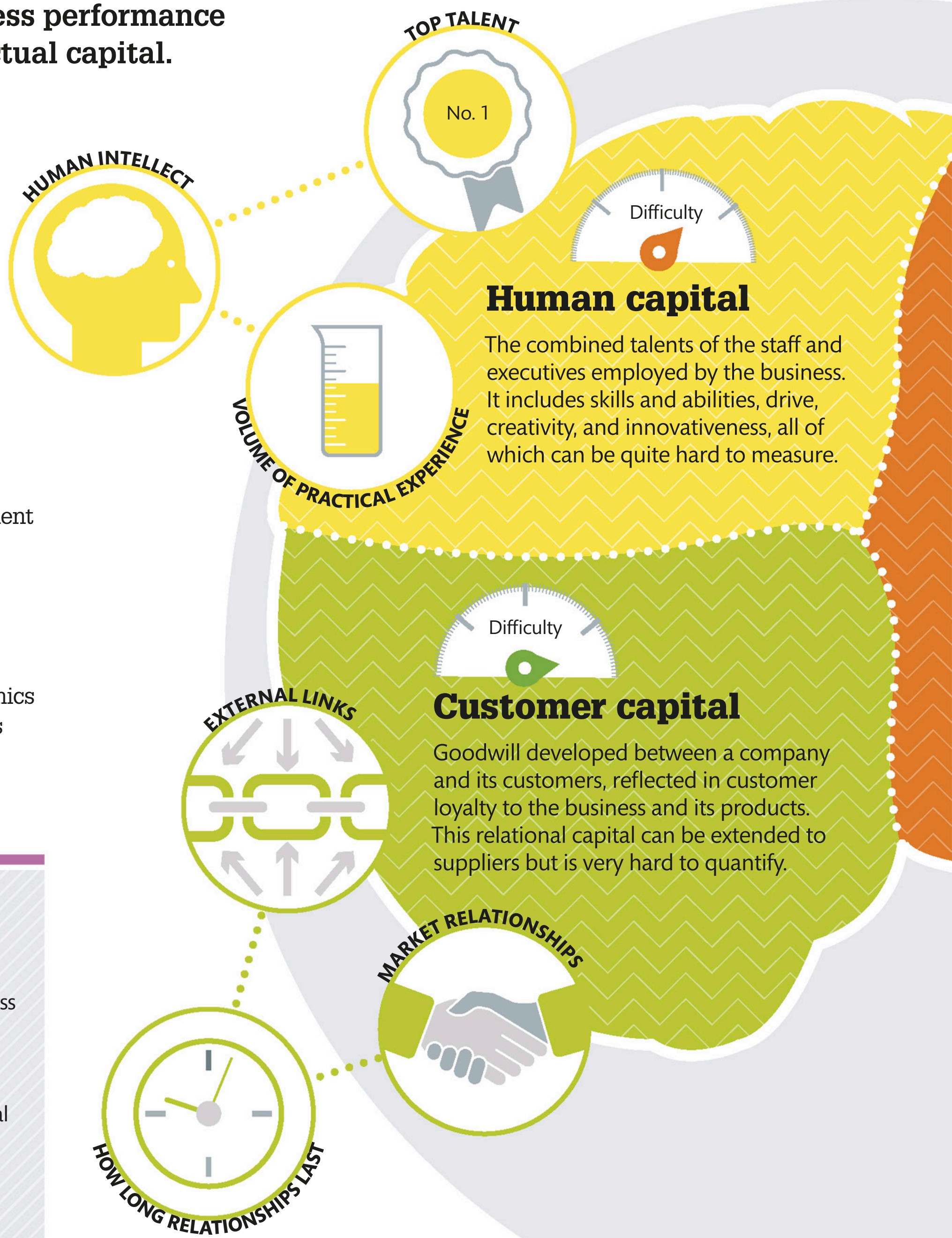
Intellectual capital

The knowledge within a company that is used to improve business performance is known as its intellectual capital.

How it works

Every business has capital, which refers to the physical, tangible assets that appear on the balance sheet of its financial statements.

A business also has intellectual capital—the knowledge and skills inside the company. This collective know-how is hard to quantify and measure, but it is essential to a company's ability to generate revenue. For instance, management must provide training and a handover period for new staff so that human capital does not go down when people leave the company, taking their expertise with them. Management academics have identified three main kinds of intellectual capital: human, structural, and customer.



Human capital

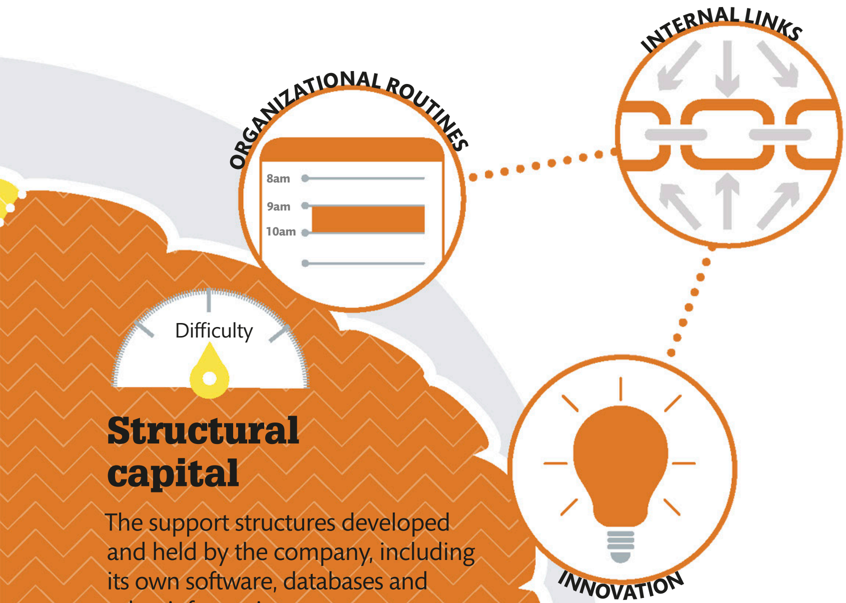
The combined talents of the staff and executives employed by the business. It includes skills and abilities, drive, creativity, and innovativeness, all of which can be quite hard to measure.

Customer capital

Goodwill developed between a company and its customers, reflected in customer loyalty to the business and its products. This relational capital can be extended to suppliers but is very hard to quantify.

NEED TO KNOW

- **Strategic capital** A company's knowledge of its market and the business model needed for success
- **Intellectual property (IP)** Creations or inventions that are legally recognized as belonging to a particular entity or individual on a balance sheet
- **Intangible capital** All knowledge assets belonging to a business or organization; can be audited under various systems (*see far right*)



Structural capital

The support structures developed and held by the company, including its own software, databases and other information systems, patents, copyrights, and trademarks. Structural capital is nonphysical, so it can be hard to assess.

> "The only irreplaceable capital an organization possesses is the knowledge and ability of its people."
>
> Andrew Carnegie, *industrialist*

MEASURING INTELLECTUAL CAPITAL

Measuring intellectual capital precisely is impossible because it is intangible, but its value to businesses means it is helpful to try to quantify it. There is no consistent way of doing this, but there are a few common approaches.

Market Value to Book Value Ratio

This looks at the difference between the financial value of the company, its book value—the difference between assets and liabilities—and the market value, which is the value of its shares. The difference includes intellectual capital and growth prospects.

The Skandia Navigator

This was developed by Leif Edvinsson, director of Swedish company Skandia, who created a model for quantifying intangible assets under five groupings—finance, customer, process, renewal and development, and human. This enables companies to understand how the difference between the market value and the book value of the business is calculated.

The Balanced Scorecard

Developed by U.S. academics Robert Kaplan and David Norton, the Balanced Scorecard system (*see p.147*) uses four categories—learning and growth, business processes, customers, and finance—to measure intellectual capital alongside financial data. For example, analyzing learning and growth provides insight into a company's human capital, while looking at business processes might reveal, say, whether intellectual capital invested in manufacturing improvements is having an effect.

Information management

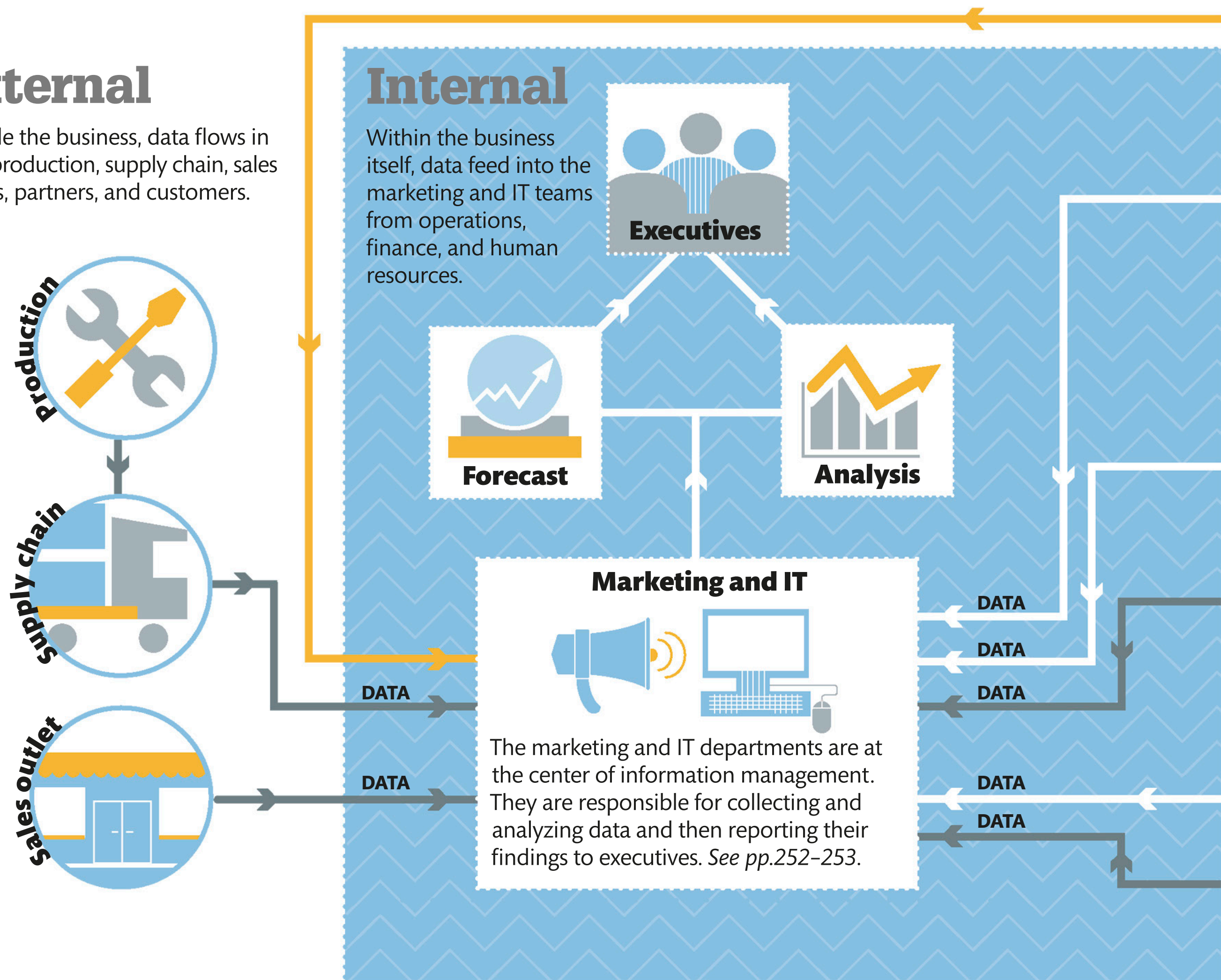
Monitoring the marketplace and making sense of the vast quantities of data available have become priorities for businesses; the data are crucial for digital marketing, which is taking on increasingly sophisticated forms. Most businesses have a system in place for managing information—and the most successful ones use data not only to monitor day-to-day performance at every level but to predict future outcomes and plan accordingly.

External

Outside the business, data flows in from production, supply chain, sales outlets, partners, and customers.

Internal

Within the business itself, data feed into the marketing and IT teams from operations, finance, and human resources.

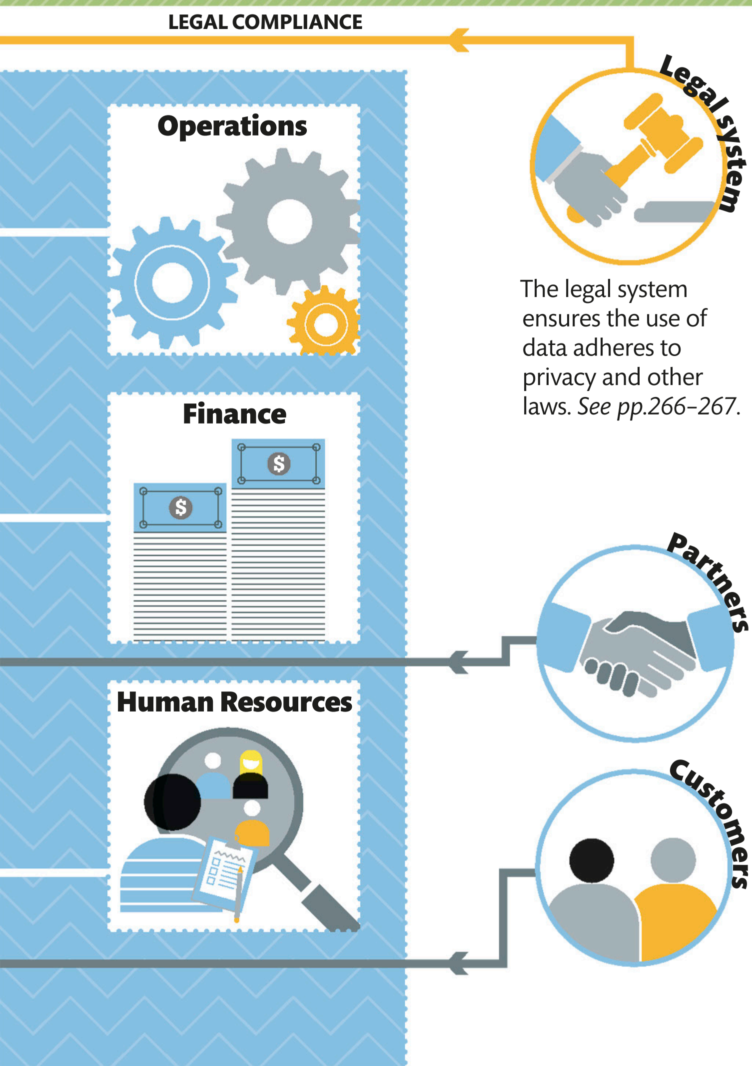


Marketing and IT

The marketing and IT departments are at the center of information management. They are responsible for collecting and analyzing data and then reporting their findings to executives. *See pp.252–253.*

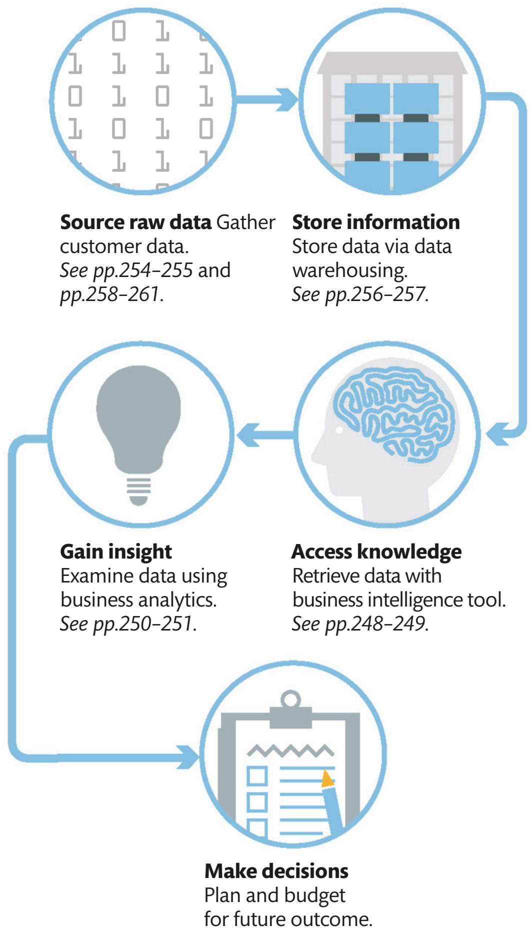
50%

of organizations employed a chief digital officer in 2019–up from 7% in 2014.



TRANSFORMING DATA INTO DECISIONS

With relevant data easily accessible (*see pp.262–263*), a business can identify its strengths and weaknesses in order to improve its processes and operations as well as its customer relationships (*see pp.264–265*).



Business intelligence

Business intelligence (BI) is an umbrella term referring to the variety of software applications companies use to access and analyze the massive amounts of raw data they have at their fingertips.

How it works

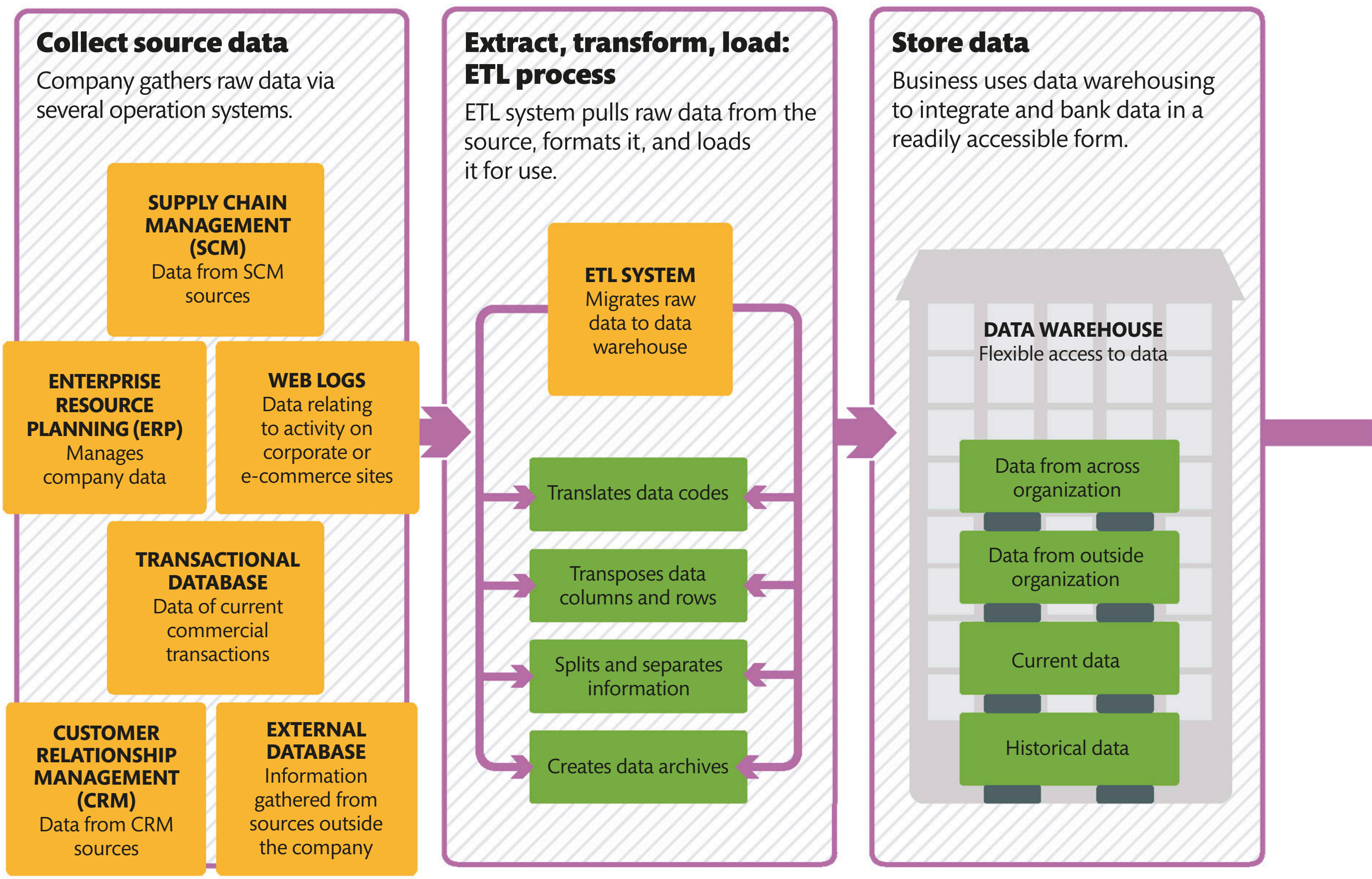
BI relies on software programs and computerized systems for collecting and integrating data so that a business can report on its activities, both past and present. The tools allow staff to pull relevant data from the company database. The marketer then views the information on a computer screen by using a data visualization tool known as a dashboard, which can also be used for real-time monitoring of business operations.

NEED TO KNOW

- **Star schema** Simplest format of online analytical processing (OLAP) in data warehouse
- **Data quality (DQ)** Condition of company's master data, which should be complete and accurate
- **Slice and dice** Process in which large amounts of data are broken down to help analysis

Business intelligence process

BI tools allow retrieval of specific relevant data by specifying the terms of the intelligence they need (such as real-time sales compared to previous year's sales).



21% of employees worldwide are fully confident about their data literacy skills.

Retrieve and analyze

Staff can fetch data to answer specific questions about what is happening in the company.

SPREADSHEETS
Form primary BI tool to display data (basic or advanced)

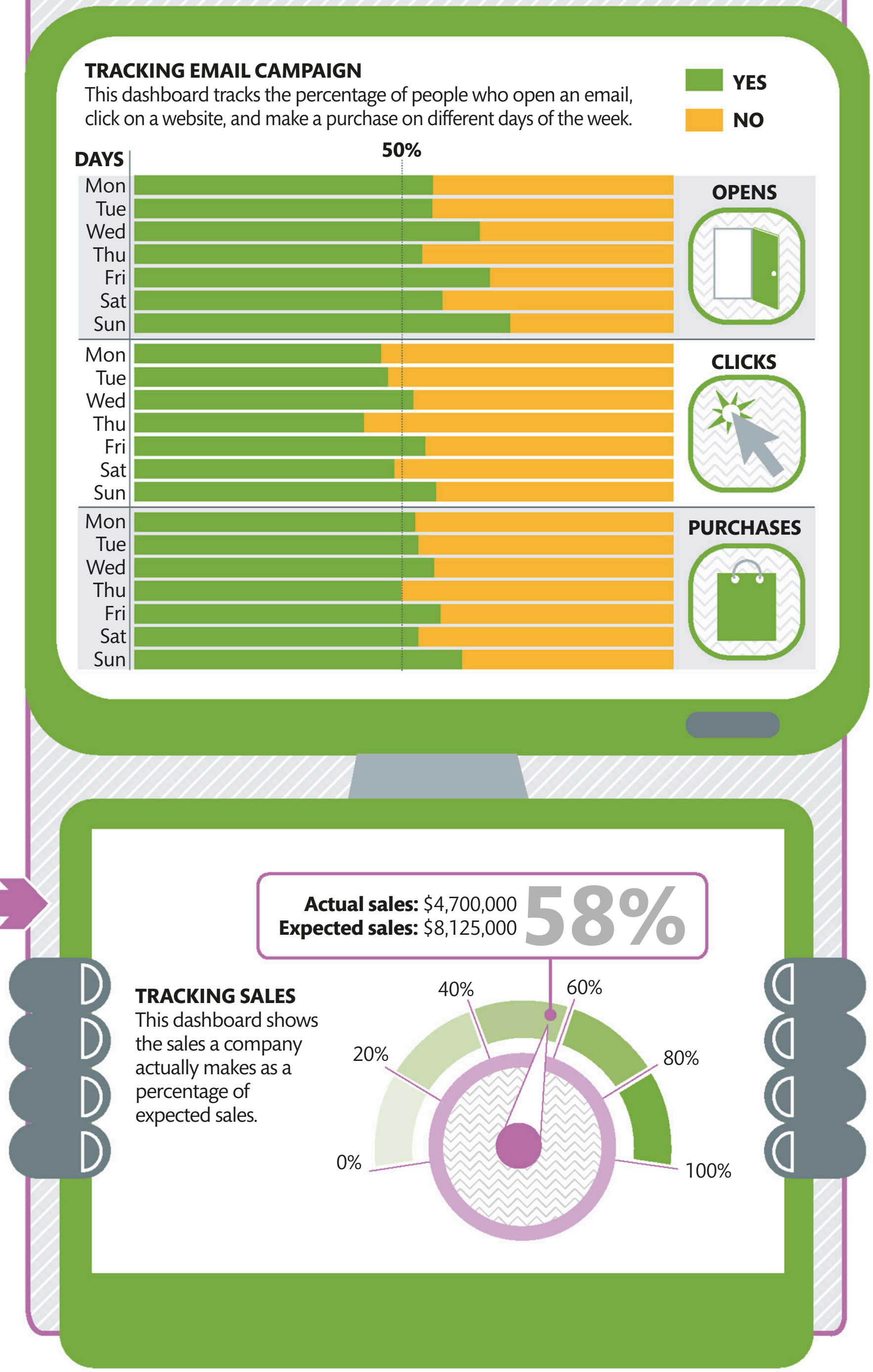
OLAP CUBES
Enable 3-D analysis of three variables on spreadsheet

DATA MINING
Allows the sifting of data to find patterns and relationships

REPORTING TOOLS
Help users develop and produce reports

Digital dashboard

Displays regularly updated business results using customized graphics.

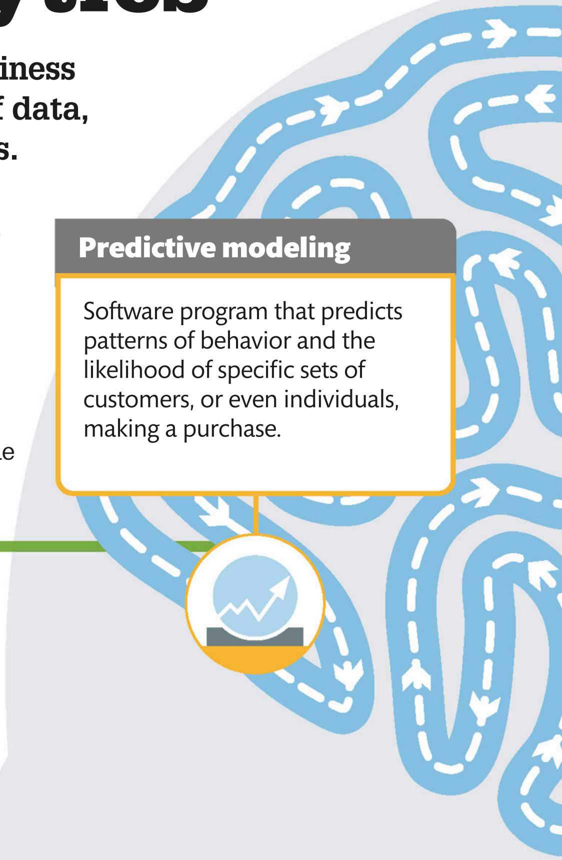


Business analytics

More cutting-edge than business intelligence (BI), business analytics (BA) allows advanced statistical analysis of data, which is used to help make future business decisions.

How it works

BA takes a scientific approach to interpreting information. Businesses use BA's advanced software tools to analyze information about past or current trends and behavior to predict a future scenario. Unlike business intelligence or predictive analytics that analyze current and past data, BA allows businesses to forecast with a high degree of confidence. BA can be applied on a macro level to get a broad view of future business performance and on a micro level to assess, for example, the likelihood of individuals in niche markets making purchases.



Predictive modeling

Software program that predicts patterns of behavior and the likelihood of specific sets of customers, or even individuals, making a purchase.

Business analytics process

A skilled analyst interprets the raw data by using BA tools. The results influence the business actions that will be taken in the future.

BUSINESS INTELLIGENCE AND BUSINESS ANALYTICS

The example of a 5 percent sales dip shows how BI and BA can be used to examine and understand the situation.

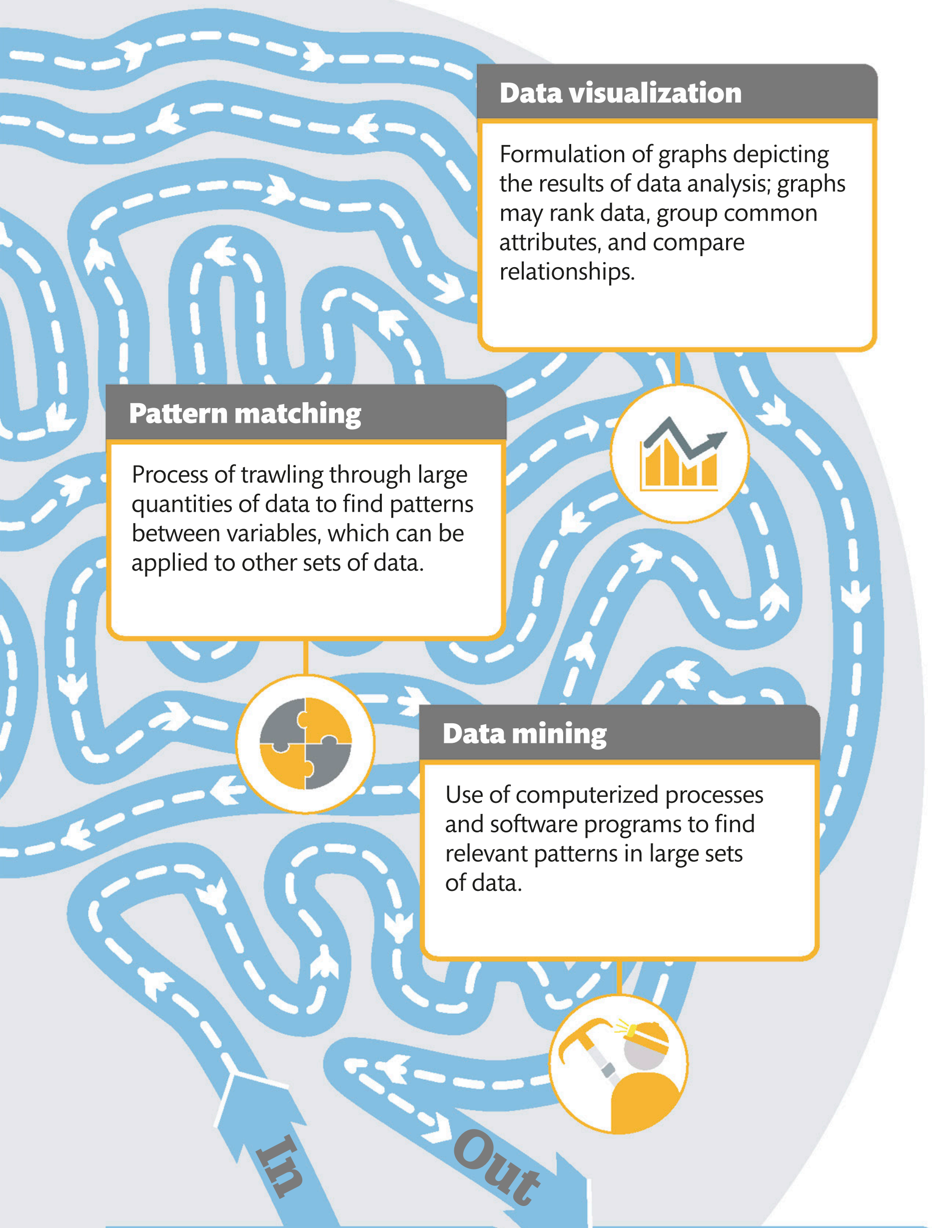
Business intelligence

- **Type of data investigation** Results reveal past and current events in the business.
- **Questions answered** What has happened in the business in the past, and what is happening currently?
- **Tools used** Reporting, dashboards, scorecards, online analytical processing (OLAP)

Business analytics

- **Type of data investigation** Examines past event in the business and applies the patterns discovered to a future scenario.
- **Questions answered** Why did it happen? Will it happen again? What can we do to stop it from happening again?
- **Tools used** Statistical analysis, data mining, pattern matching, predictive modeling

81%
of managers globally have access to analytics, but only half of front-line employees do.



Data visualization

Formulation of graphs depicting the results of data analysis; graphs may rank data, group common attributes, and compare relationships.

Pattern matching

Process of trawling through large quantities of data to find patterns between variables, which can be applied to other sets of data.

Data mining

Use of computerized processes and software programs to find relevant patterns in large sets of data.

Raw data

This includes company records (past and current customer data and transaction histories) and external data (economic, trade, and industry reports).

Analysis

Software tools are used to process and study raw data. Analysts interpret results and make forecasts that help future business decisions.

DATA USEFULNESS

Some data are more useful than other data; value is determined by the extent to which marketers can use the info to make confident forecasts. Methods of interpreting data are increasingly sophisticated.

Predictive analytics
Program that conducts advanced analysis of data to forecast future outcome

Monitoring
Process that uses software to show what is currently happening in a business, providing real-time results to help key operations make decisions

Statistical analysis
Software that organizes and investigates every piece of relevant data and interprets it to show trends and patterns

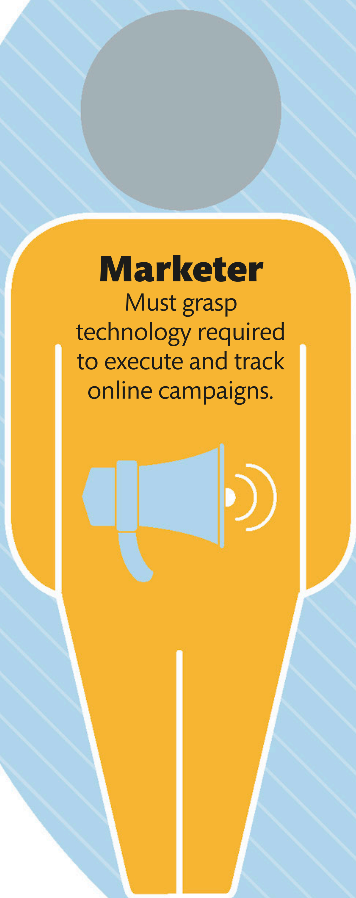
Reporting
Method that draws on historical data to provide a general overview, revealing, for example, how the business performed in a given year

Marketing and IT

The use of digital marketing strategies means that marketers are working more closely with IT specialists to develop the best ways of launching and managing online publicity campaigns.

Convergence of marketing and IT

Communicating with customers online is a vital part of many businesses. As a result, marketing relies so much on IT that in some companies, marketing teams spend more money on technology than their IT departments do.



Areas of overlap

Digital marketing

Developing a technology program for publicity campaigns

Real-time transactions

Installing a system for recording and tracking online sales as they happen

Big data

Locating key statistics from vast amounts of online information to improve marketing

Data analytics

Using advanced tools to gather and analyze data for developing future marketing strategy

Mobile technology

Understanding and keeping up to date with advances in mobile applications and e-commerce potential

Data storage

Building infrastructure and software for storing and retrieving sales, campaign, and customer history

Social media

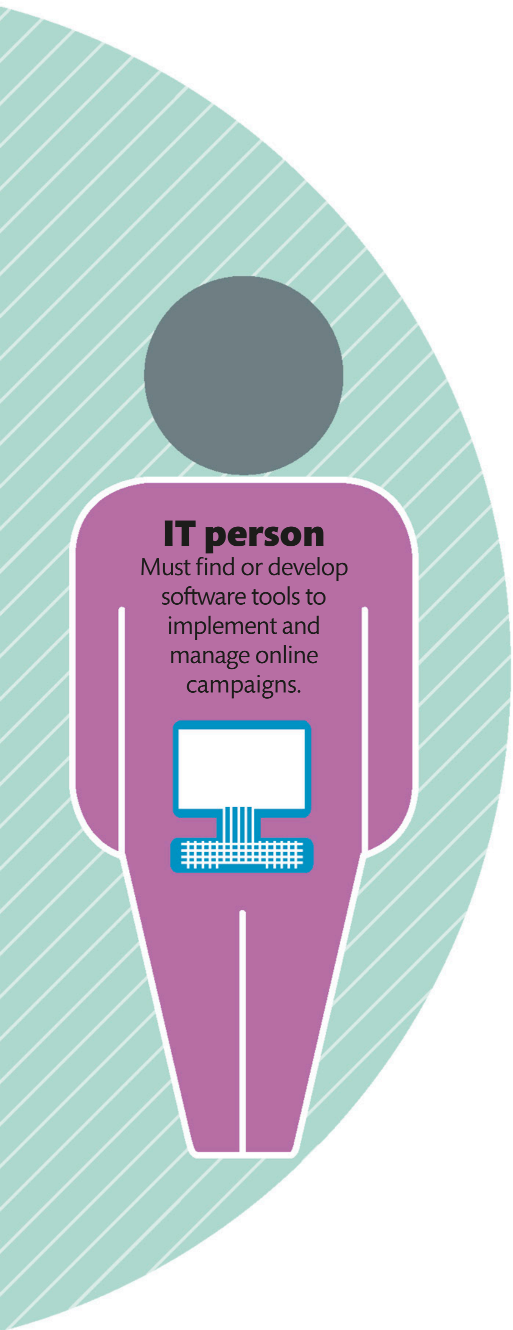
Developing the best methods for increasing online traffic via social media channels

Tracking

Following a customer through the online engagement and sales process

How it works

Marketers need to know how to use technology to increase revenue. At the same time, chief information officers (CIOs) have adapted to changes in external technology. The responsibilities of marketing and IT departments often overlap, with the hybrid professional role of marketing technologist (*see below*) sitting between the two fields.



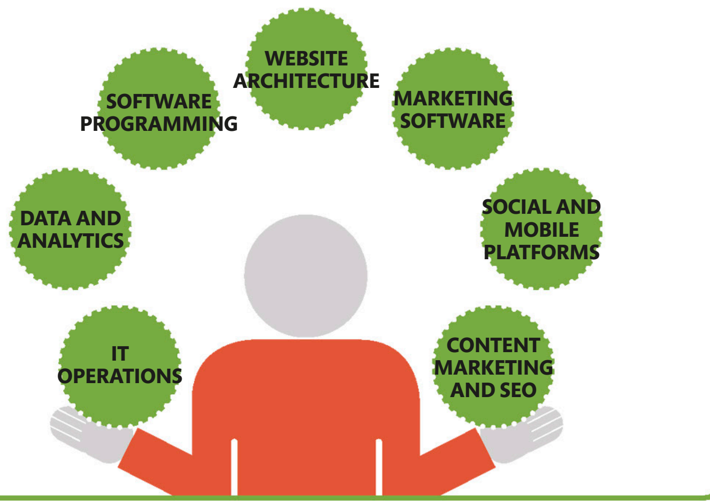
8,000 marketing technology tools are available to businesses

NEED TO KNOW

- **MarTech** Annual business conference that focuses on overlap of marketing strategy and technology
- **Actionable metrics** Measurements of campaign results that enable businesses to make informed decisions
- **Vanity metrics** Measurements of campaign results that appear positive but are not meaningful
- **Growth hacking** Low-cost online marketing techniques, such as using social media to improve sales

THE MARKETING TECHNOLOGIST

Online marketers rely on software to monitor and analyze campaigns, generate content, and extract data. The job of the marketing technologist, who has knowledge of both marketing and IT, requires a broad knowledge base.



Collecting consumer data

Capturing key data is a priority for any business seeking to understand the marketplace. However, it requires using innovative strategies to overcome consumer concerns about privacy issues.

How it works

There are a number of methods companies use to collect customer data. When there is contact between a customer and the company, marketers can use the opportunity to gather as much information as possible. This might happen at the point of sale in a store or online, where marketers are able to observe customer behavior.

Marketers may also choose to solicit information directly by asking their customers to fill in registration forms and conducting telemarketing calls or customer surveys.

WARNING

Data collection errors

- **Barraging** Using a customer's data to bombard them with information on products viewed or sites visited
- **Overlooking technical flaws** Failing to integrate apps properly, leading to inconsistency (and errors) in collecting customer data
- **Using only automated systems** Neglecting the opportunity to strengthen relationships with customers by communicating with them personally

Collecting data to create consumer profile

Digital marketing and e-commerce have accelerated the rate at which customer information is gathered. Some methods require the customer's input, such as questionnaires that appear online. Others, such as website tracking, are possible without the need to contact the customer.

Surveys
Gather customer feedback via email, text, mail, or face-to-face questionnaires.

Observations
Study customer's behavior while they shop in a store or online.

Customer research
Conduct research on existing customers or on those who fit the customer profile.

Contact center
Monitor customer calls and store data on preferences and purchase history.

Social media
View customer's profile information on social media.

Website trackers
Track website visitor's movement around a site and see what attracts interest.

Competitions
Use competitions to collect information, from opinions to demographic data.

Transactions
Ask questions at checkout—in the store, online, or on the phone.

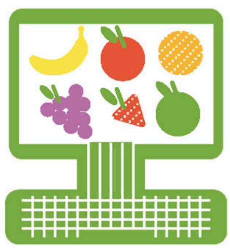
10% of global Internet users run ad-blocking software, which can stop online data tracking.

TECHNOLOGY AT THE CHECKOUT

In this technological age, businesses have the means to learn about their customers without bombarding them with questions. Retailers, for example, typically use three methods in stores to capture information about the customer.

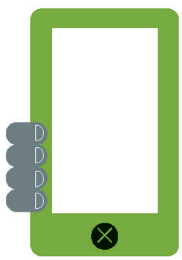
Loyalty program

A company may collect information by inviting customers to register for a loyalty program that offers an incentive. A loyalty program also helps track customer preferences.



Point-of-sale software

Computer software programs that track a customer's purchases are available, allowing marketers to tailor offers to their spending habits.



Mobile technology

The use of smartphones enables marketers to compile data, such as the frequency of customer visits and the amount of time they spend in the store.

Data warehousing

The process of data warehousing involves information from a company's internal system, such as invoices and sales logs, as well as data from outside sources being filed away in a secure digital vault.

How it works

The data warehouse is a repository that holds the company's sales and operational history as well as relevant economic and trade information from other sources. The information goes through three stages as it enters the warehouse—first it is *extracted* from source, then it is *loaded*, and finally, it is *transformed* into usable formats. Together, this is known as the ELT process. Once stored, the data may be accessed by all areas of a company—from accounts to operations to sales. The data are often used to assess beliefs about the business. For example, the marketing manager of a power tools company might presume that 25- to 35-year-old men are more likely to purchase its products than women in the same age bracket. They would test this belief by analyzing sales data and customer records accessed from the data warehouse.

$51 billion

predicted size of the data warehouse market in 2028

Warehousing process

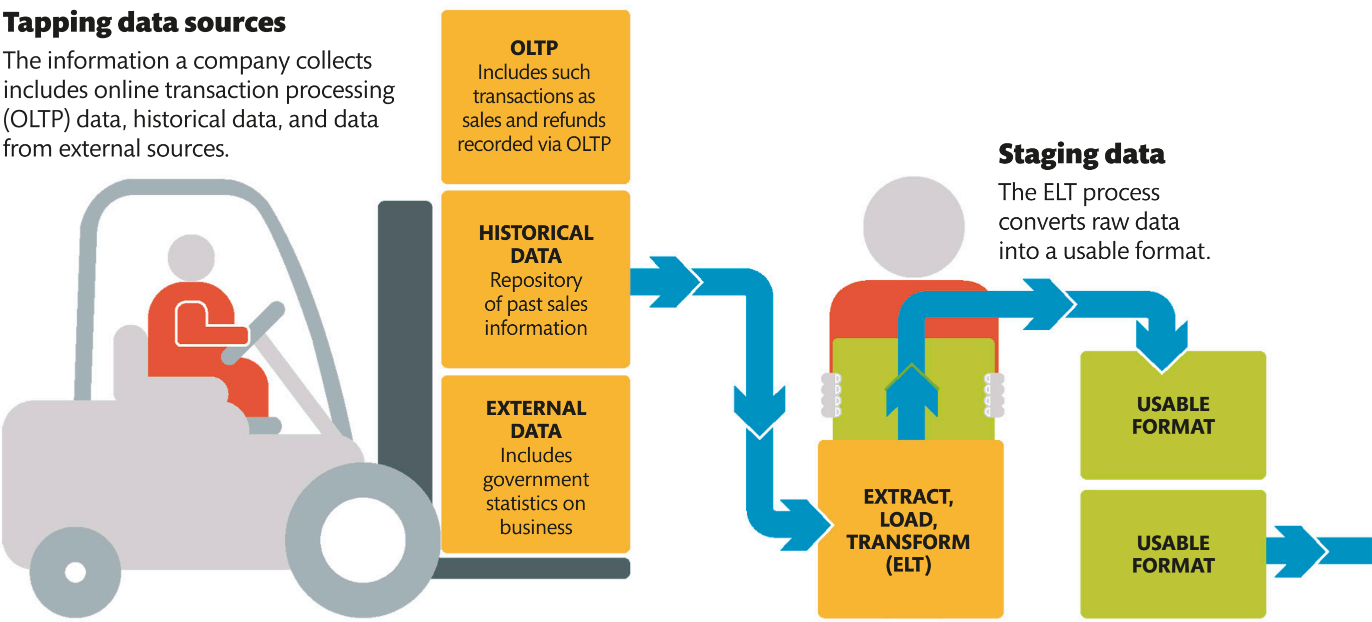
The data stored are regularly updated. When the business requires information from the warehouse, the information is transformed into an accessible format and analyzed using software tools. Data can be stored on in-house servers or on external servers in the cloud provided by a third party.

Tapping data sources

The information a company collects includes online transaction processing (OLTP) data, historical data, and data from external sources.

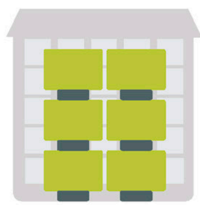
Staging data

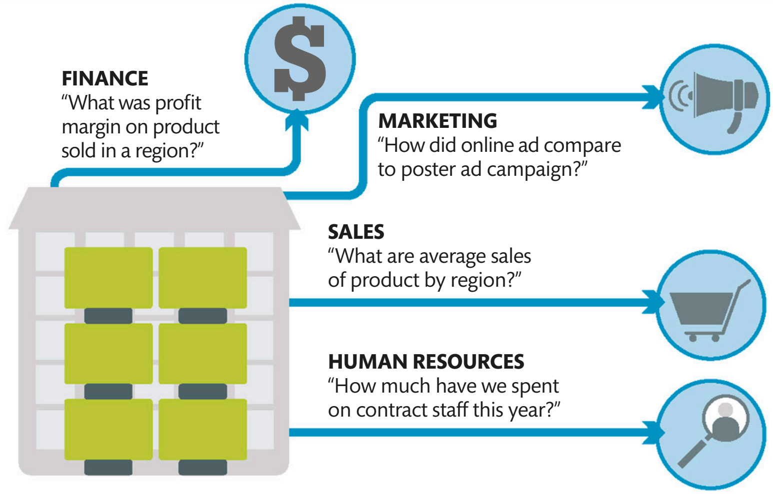
The ELT process converts raw data into a usable format.



WHO USES THE DATA WAREHOUSE?

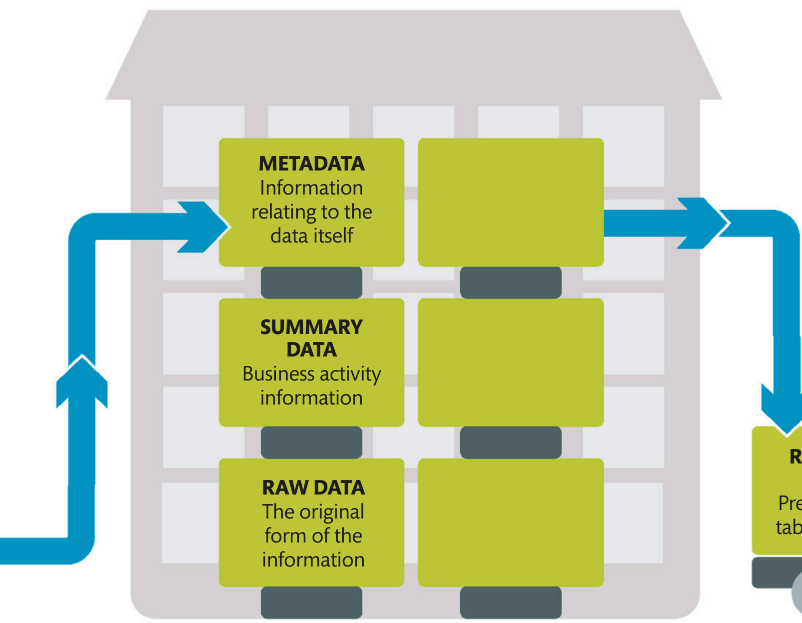
The key departments of a company can access the data warehouse to find out how they are performing. The method by which the data are formatted and stored makes it possible for them to seek answers to questions relevant to them. Typical questions various departments might ask include:





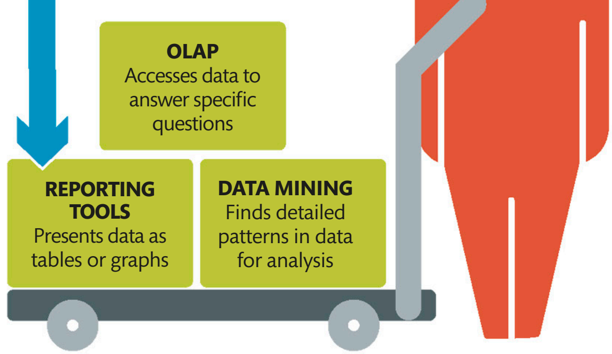
Storing data

The data are stored in three categories: metadata, summary data, and raw data.



Accessing data

Using software tools, the data can be analyzed and retrieved in three ways: via online analytical processing (OLAP), reporting tools, and data mining.

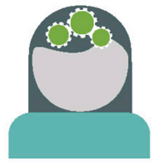


Customer profiling

Marketers can create detailed portraits of customers by using internal company data on their purchase habits, preferences, and lifestyles and cite external data sources to learn about attitudes and social trends.

How it works

In order to best understand their audience, marketing departments define their ideal customer by developing a customer profile. They build this profile by gathering information about the kind of person who usually buys the type of product they wish to introduce to the marketplace. The information they look at includes basic data about a person, such as gender, age, occupation, and salary, as well as more detailed ideas concerning the person's typical spending habits, such as the places where they like to shop and the amount they tend to spend.

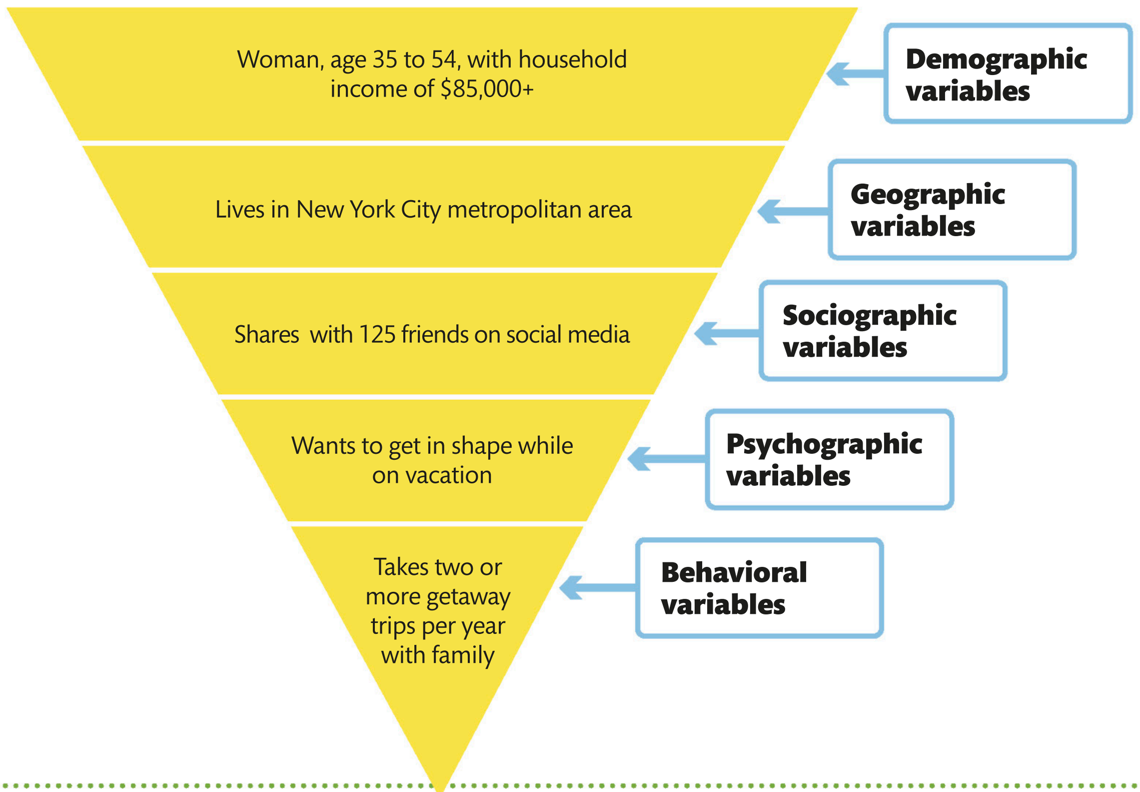


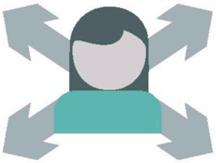
Psychographic view

- **Personality** Outspoken; likes to stand out from the crowd
- **Attitude** Positive outlook and enjoys the good things in life
- **Ethic** Works hard and believes in contributing to social causes

Segmentation model

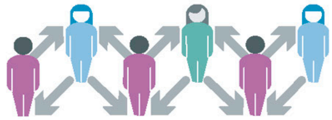
By constructing a segmentation model, layered with a number of variables (different levels of information) about consumers, marketers can gradually create a clear picture of their ideal target customer—in this case, for a travel company.





Behavioral view

- **Shopping location** Prefers to shop in smaller stores
- **Purchasing habits** Buys in bulk to save money, responds to discounts
- **Degree of loyalty** Faithful to a brand but open to better offers



Sociographic view

- **Social media** Actively shares interests with connections
- **Community** Influential member who socializes and contributes to neighborhood
- **Groups and clubs** Member of bird-watching and hiking groups

83% of consumers are happy to share their data to get a personalized experience.

Customer profile dimensions

What does the ideal customer look like? Where do they live? What do they spend their money on?

Geographic view

- **Continent** North America
- **City** Booming metropolis with work and social opportunities
- **Climate** Varies from below freezing in winter to hot and humid in summer

Demographic view

- **Age group** 35–54 (helps gauge family priorities and income)
- **Status** Married (children affect spending choices)
- **Occupation and salary** Teacher, $65,000

Creating a customer profile

By constructing a profile of an existing customer by using data from within the company, marketers have a clearer view of the buying patterns and habits of an individual. They can then make projections about the long-term value of that individual as a customer.

WEBSITE DATA
How often do they visit the site? Which web pages do they look at?

SOCIAL DATA
Which social media networks are they connected to? Do they share links?

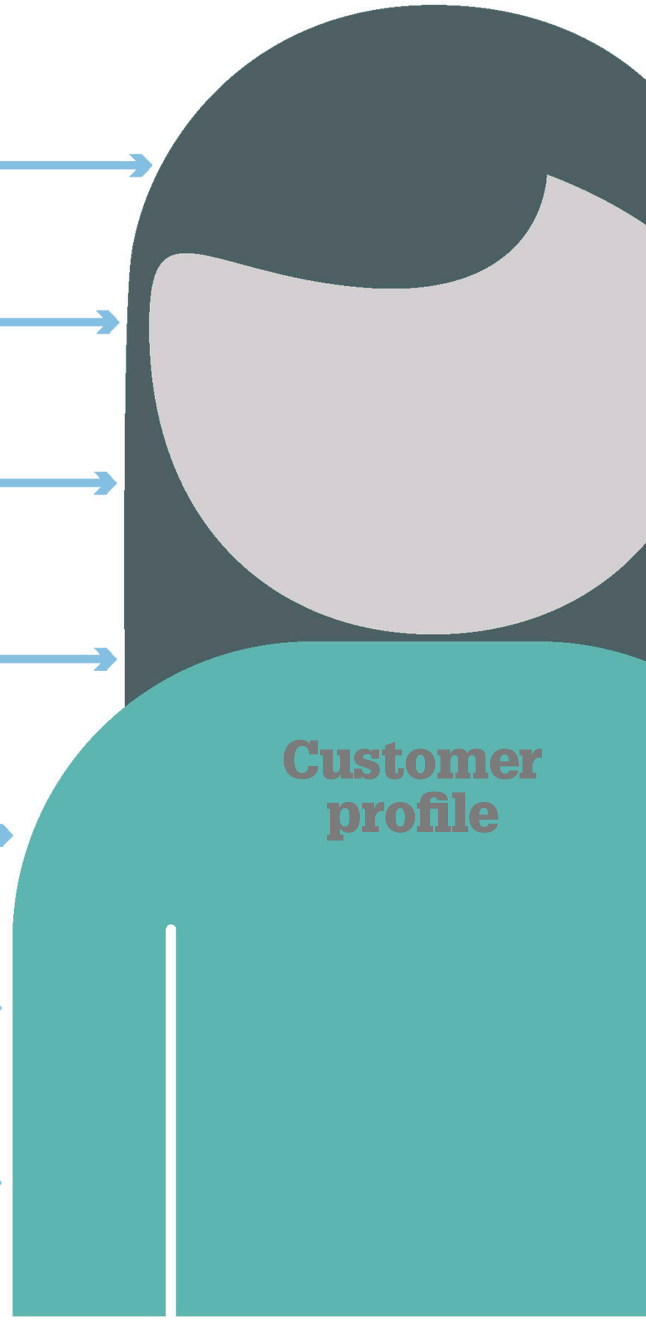
TRANSACTION DATA
How much have they spent, how often, and on which products?

CRM DATA
What's their contact history with call centers? How have they responded to campaigns?

LOYALTY DATA
How loyal are they to the company? Do they use the company loyalty program?

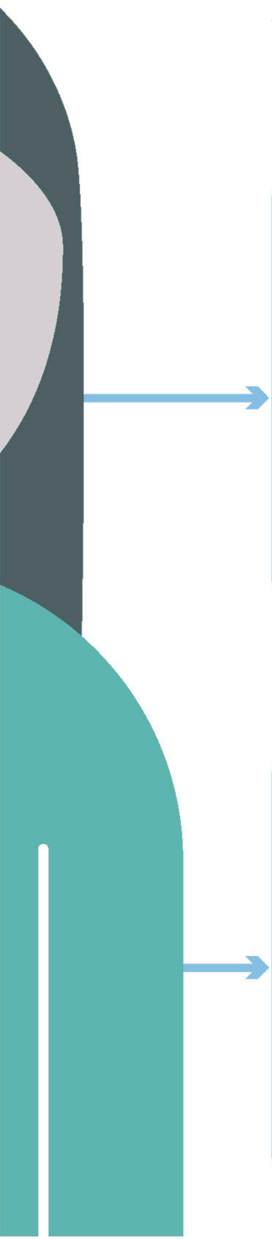
MAIL DATA
What email contact has there been? What has the response rate to emailed content been?

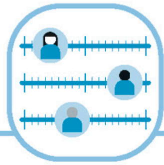
POINT OF SALE
What observations have sales staff made from interacting with customer?



"Once you understand customer behavior, everything else falls into place."

Thomas G. Stemberg, *founder of office supplies retailer Staples*





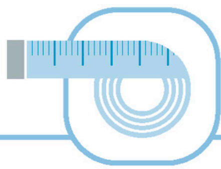
Assessing customer profile

Good customer

- Returns frequently to make repeat purchases
- Responds to marketing and in-store promotions
- Shares favorite products on social media networks
- Signs up for newsletters and special offers

Bad customer

- Bombards call center with complaints
- Frequently returns products for full refund
- Never joins loyalty programs or signs up for newsletters
- Spends less money than the cost of courting them



Three ways to use a customer profile

1 **Tailor content to suit customer** By sending out personalized messages and experiences, businesses engage customers and build a long-term relationship.

2 **Sell more to existing customer** Mining customer profiles to see their spending habits, likes, and interests enables marketers to make personalized offers.

3 **Reward loyal customers** Identifying good customers and offering gifts and incentives tailored to their tastes increase customer lifetime value.

SEGMENTATION SYSTEMS

Once marketers have gathered data and identified their ideal customer profile, they can compare their customer to a number of commonly used systems of segmenting, or characterizing, consumers. In the U.S., there are many systems, but one of the most well-known is the Nielsen company, which uses more than 60 segments that have names like "Boomtown singles" and "Up-and-comers."

In the U.K., customers may be compared to the simple system of socioeconomic class:

- A **Managerial and professional**
- B **Middle management**
- C1 **Clerical and junior management**
- C2 **Skilled manual workers**
- D **Working class**
- E **Nonworking and low-paid workers**

NEED TO KNOW

- **Omnichannel customer** Consumer who shops using multiple channels, including store visits, mobile apps, and websites
- **Loyads** Customers who are loyal to a provider and champion them, bringing in other customers in the process
- **360-view** Profile that gives marketer a complete picture of a customer, making it possible to predict their needs and behavior

Big data

Business is trying to harness the huge amount of consumer data now available online. This information can be analyzed and used to create detailed profiles to target customers more precisely.

How it works

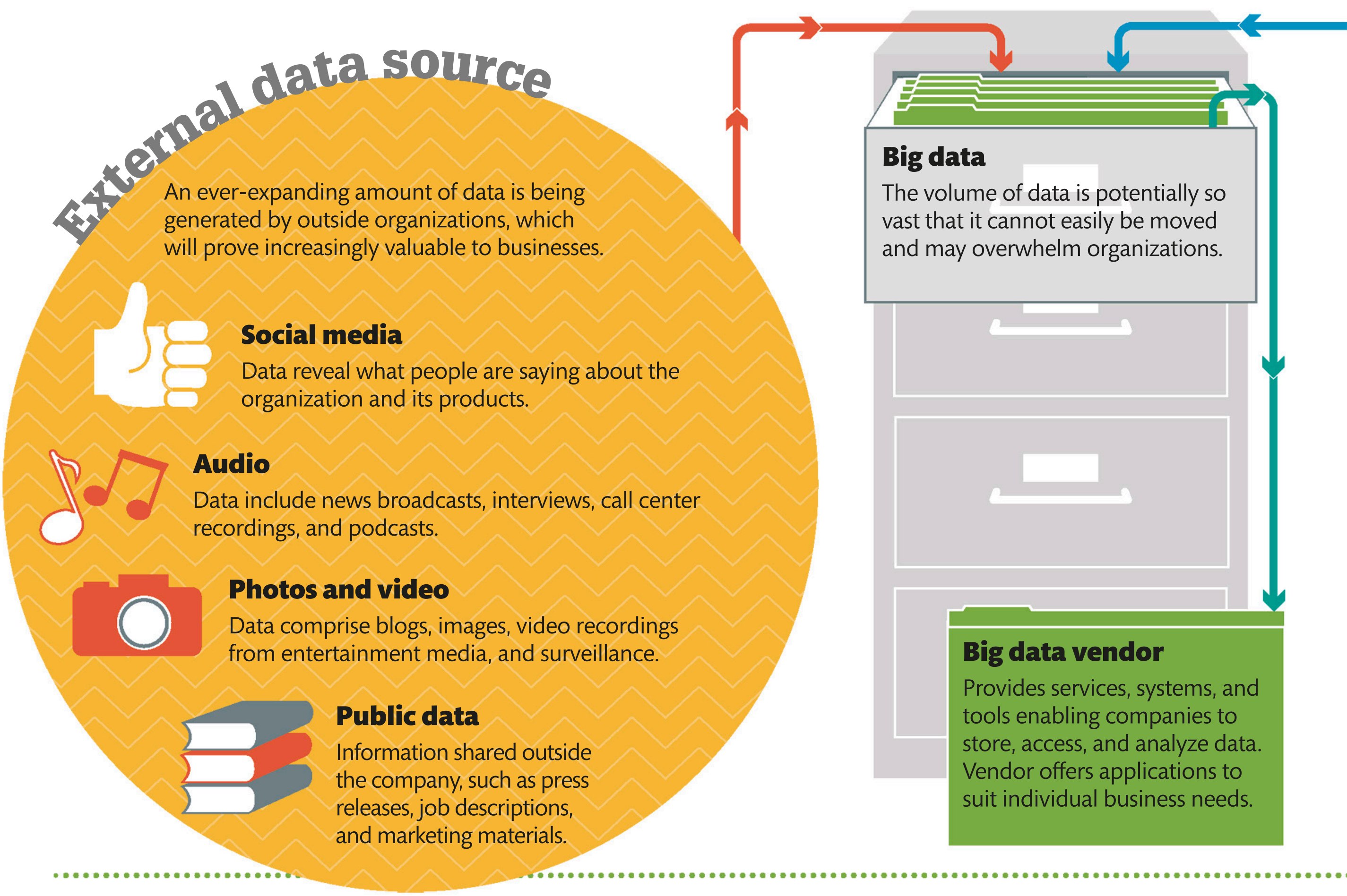
Big data is the huge amount of digital information transmitted via the Internet every day. It is streamed at high speed and in many different formats, from database statistics to video, audio, and email documents.

The challenge for most organizations is to sift through big data to find information that has the potential to add value to their business. Software tools are available that can analyze the masses of external data generated on the Internet.

Internally and externally mined big data

Businesses are able to access data from such sources as mobile communications, social media networks, and commercial transactions, which show the activity of billions of people.

Big data store



50–80%

of data scientists' time is spent preparing data before it can be used.

Internal data source

Internal data sent to the big data vault, where it is traced and recorded, are drawn from all parts of the organization and form a unified database.

Transactions
- Spend per customer
- Foot traffic in stores
- Time spent per visit

Log data
- Customer reviews
- Customer service
- Audio files of customer service calls, for example

Emails
- Internal communications
- Customer contacts
- Email campaigns

NEED TO KNOW

- **Apache Hadoop** Open-source software library for storing and processing big data
- **Terabyte** One trillion bytes
- **Petabyte** Unit of digital data equivalent to 1,024 terabytes (one petabyte equates to 341 million three-minute songs on MP3)
- **Exabyte** Unit of digital data equivalent to 1,024 petabytes (five exabytes equates to all words ever spoken by human beings)

INFORMATION OVERLOAD

The volume of data typically generated online every second:

- **Emails** 3,048,134 sent
- **Tweets** 9,570 sent
- **Instagram** 1,088 images uploaded
- **Skype** 5,853 calls
- **Internet** 123,432 GB of traffic
- **Google** 93,823 searches
- **YouTube** 90,694 videos watched

DATA MANAGEMENT

Organizations can choose either offline or online options to store big data and various software programs for access and analysis.

- **Big storage hardware** Servers; storage and network equipment capable of supporting many terabytes of data
- **Software** Includes programs for research and analysis, storage and access, and graphic visualization of data
- **Cloud services** Third-party providers that offer storage networks for big data management and access

Customer relationship management (CRM)

CRM (customer relationship management) is a computerized system used to manage and coordinate marketing, sales, and customer-support data to maintain good customer relations and improve profitability.

How it works

CRM is a software tool in the company's IT system that records all interactions the business has with customers. The information can be used in a number of ways: the sales team may use it to find new business leads and improve relationships with existing customers, the marketing team may use it to reward loyalty, and customer service may use it to deal with problems.

NEED TO KNOW

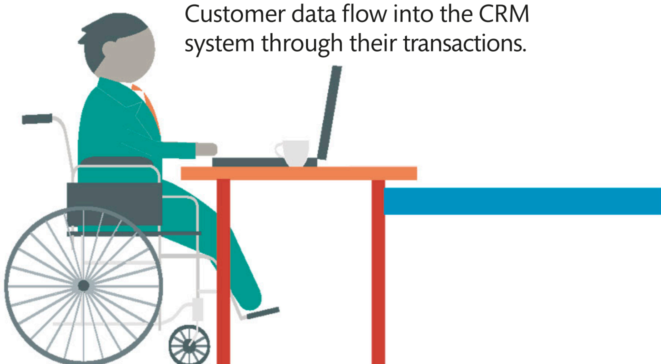
- **Technology-enabled relationship management (TERM)** Use of automated processes to manage customer relationships
- **Enterprise resource planning (ERP)** Precursor to CRM
- **Cloud-based CRM** Computerized CRM system that exists in a technology cloud

CRM system

The system uses reliable processes that allow companies to connect more efficiently with customers and ultimately offer better service, resulting in long-term gains for the company.

Customer

Customer data flow into the CRM system through their transactions.

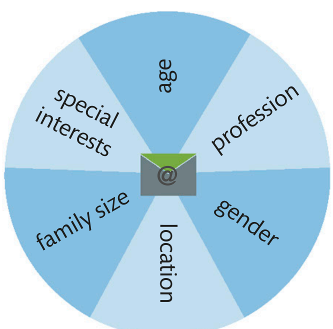


AUTOMATION

CRM can use automation as a tool to respond to customers who visit and use a website.

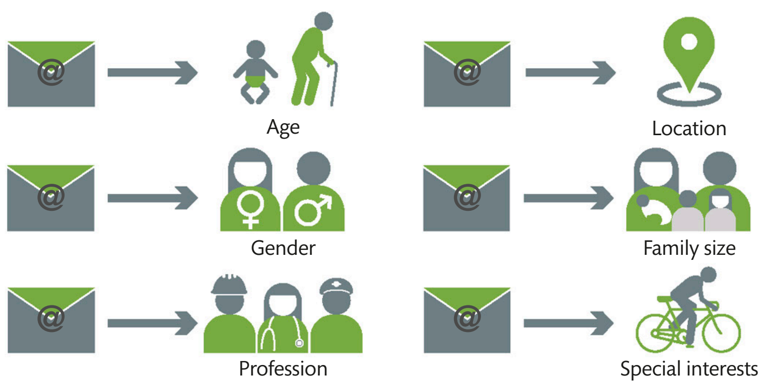
Customer segmentation

The market can be segmented into groups relevant to the product the company sells.



Email campaign management

Different emails are sent automatically to the relevant groups.



871%

the average return on investment delivered by CRM

Marketing
Target groups for special campaigns; monitor and reward loyalty; generate leads

Sales
Convert new leads; find new prospects; cross-sell and upsell opportunities; customize pitches

Customer contact form
CRM uses the information to group customers according to their buying behavior.

Price quote
The company sends a price quote in response to the customer's interest in their product.

Customer feedback
The company asks questions and monitors social media to glean information about customers' views.

E-commerce transaction
The customer pays for the product via the Internet.

Support ticket
An automated ticket allows the customer to track delivery of the product.

Operations
Improve efficiency of manufacturing, product delivery, ordering, and tracking

Customer service
Respond to service issues immediately; manage customer cases; gather feedback

Finance
Generate invoices in a timely manner; manage payment process

Compliance

In most countries, companies have to adhere to laws and industry regulations that govern how they can sell and market their products. The rules are there to make sure that businesses operate fairly.

How it works

Governments impose rules on marketers to prevent any unscrupulous, misleading, or unwelcome practices, such as false advertising, the failure to disclose all terms and conditions, and spam marketing (sending unsolicited emails). The regulatory body is able to investigate any company accused of breaking the rules and impose penalties if it finds the company guilty.

Marketing regulations

To protect the consumer, regulatory bodies produce guidelines instructing companies on how they should market their products.

Business areas subject to regulation	Example of marketing practice
Comparative claims	"Our model is much better than our competitors' models!"
Endorsements	"I owe my success to their product!"
Special offers	"Buy one, get one free!"
Sweepstakes and contests	"Enter the prize drawing for the chance to win the vacation of a lifetime!"
Telemarketing	"Good evening. Would you like to save money on your energy bills?"
Marketing to children	"Step right up and enter the House of Toys..."
Customer data	"Please fill in the registration form."
Email marketing	"Today only—24-hour online sale!"
Use of spam	"Congratulations! You have been selected..."
Negative-option billing	"Please uncheck the box if you do not wish to..."

50%
of all email in 2020 was spam.

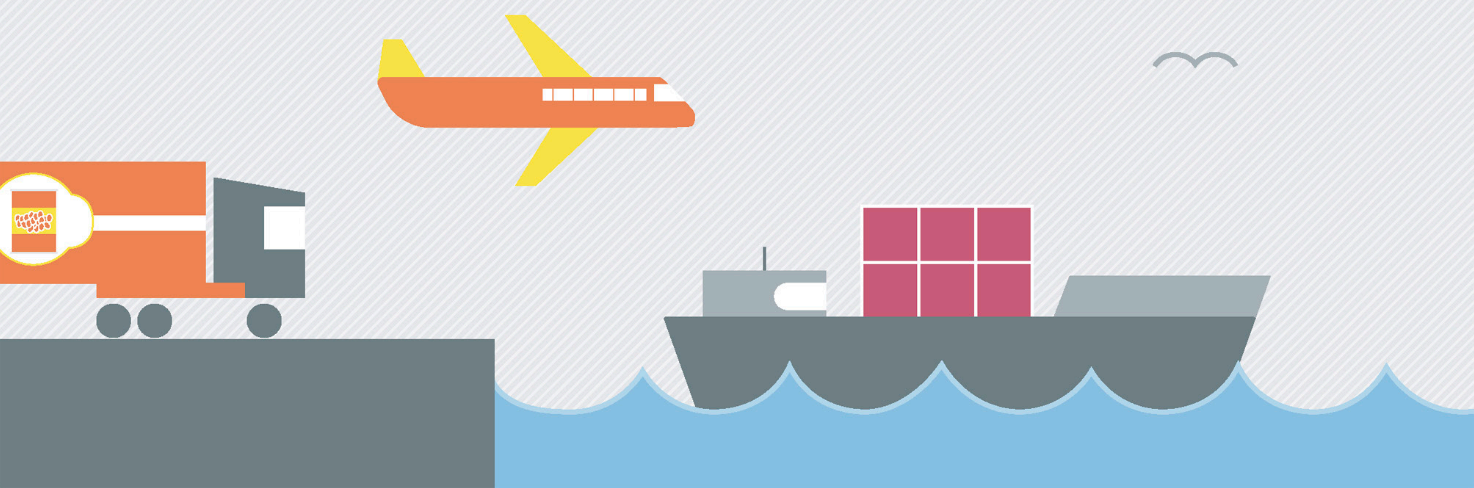
NEED TO KNOW

- **CAN-SPAM Act** International legal ruling that establishes commercial email requirements and penalties for violation
- **Phishing** Fraudulent sending of emails while pretending to be a genuine entity—to gain the recipient's bank details, for example

Typical regulations to protect consumers
✓ A marketer making a claim that it's product is superior to a rival's must be able to substantiate it with proof.
✓ A marketer must be able to prove that an endorsement by a person that they have used to promote a product is genuine.
✓ A marketer promoting a product with a special offer must set out the terms and conditions in writing.
✓ All competitions and prize drawings must adhere to legal guidelines to ensure that they are fair and impartial.
✓ Telemarketers in the US must provide key facts before an order is placed, including business name and contact, cost and quantity, restrictions and conditions, and refund policy.
✓ Marketers must stick to specific guidelines governing how they advertise and promote products to children.
✓ Customer information must be stored, managed, and used in accordance with privacy laws.
✓ Marketers in the US must not send emails to individuals unless they have given specific consent or they are existing customers. Every message must include an opt-out option.
✓ Marketers must never send bulk unsolicited emails, the most common form of spam, or other types of unrequested messages.
✓ Any item offered alongside the main product purchased must be presented as an option to buy, not an item the consumer must take action to refuse.

HOW **OPERATIONS AND PRODUCTION** WORK

Manufacturing and production ❯ Management
Product ❯ Control ❯ Supply chain



Manufacturing and production

Once a firm has decided what goods or services to supply, its directors have to choose the method of production that best suits consumer demand, the product, and the market as well as one that will be the most profitable. Companies work in three general areas of industry, which together form a production chain to provide consumers with finished goods or services.

Production methods

Before the Industrial Revolution, products were made by craftsmen. Then, factories brought people together to work on machines. Typically, this was job production, with one person making one item. Economist Adam Smith first introduced the concept of division of labor, which led to mass production, with carmaker Henry Ford popularizing the moving assembly line at the start of the 20th century. Today, manufacturers can combine the best of all methods, with large-scale production of personalized products. Production typically involves three stages—here, from navy bean to canned beans sold in supermarkets.

Primary production

The acquisition and processing of raw materials—in this case, navy beans as well as tomatoes for the sauce

PRODUCTION IN PRACTICE

Native to South America, navy beans are grown either for the immature green pods, eaten fresh as green beans, or for the beans themselves. These are dried and used most commonly in baked beans, a dish that originally came from Boston.

CHOOSING THE BEST METHOD

- **Job production** Items are made individually. *See pp.272–273.*
- **Batch production** A number of items are all made together at the same time. *See pp.274–275.*
- **Flow production** This is suitable for mass-producing identical items on an assembly line. *See pp.276–277.*
- **Mass customization** Mass product is customized by buyer. *See pp.278–279.*
- **Continuous production** 24/7 line of production runs for products with consistent demand. *See pp.280–281.*
- **Hybrid processes** This mixes batch and flow production or combines other processes. *See pp.282–283.*

$3.85 trillion

the value of China's annual manufacturing output in 2020, the highest in the world

KEY PRODUCTION FACTORS

To create products, businesses need resources, including:

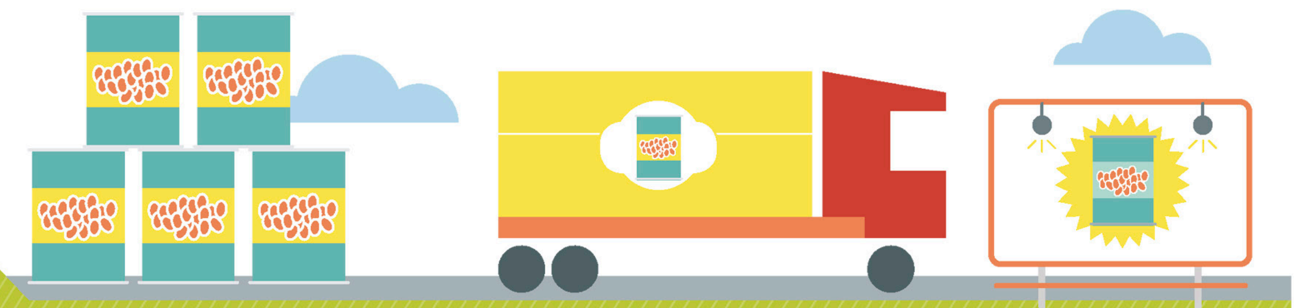
- **Capital** Money invested in business, including money spent on production tools, such as equipment, machinery, and buildings
- **Land** Natural resources used to create goods and services—for example, physical land or extractable resources, such as minerals, lumber, oil, or gas
- **Labor** People who are employed in a business and have the necessary skills to produce the goods and services
- **Enterprise** Entrepreneurs and/or leaders who bring the factors of production together to make the whole process happen

Secondary production

The manufacture and assembly of raw materials to turn them into a product or service; in this instance, baked beans

Tertiary production

Services that support the production and distribution of the baked beans, such as transportation, advertising, warehousing, and insurance



The raw beans are mixed with tomato sauce, sugar, salt, and secret spices. The ingredients are cooked in vast pressure cookers, ensuring consistent texture and a long shelf life, and then sealed in cans.

The labeled cans are transported to warehouses and from there to supermarkets and other outlets to be sold. Several brands vie for market supremacy of this popular convenience food, using advertising, price, and taste differentiation.

Job production

In job production, items are made individually. Each item is one job, which is usually finished before another is started. This method is often used for small-scale production or for large one-time projects.

How it works

Job production is best suited to a business that has to meet specific customer requirements. Typically, these are unique requests, which an individual or a team handles from start to finish. Custom-made suits or furniture are examples. The scale may be small, and firms often start with job production because it is simple and little investment is required. Job production can also be used for complex projects and those involving leading-edge technology, including film production; major construction, such as ships for the navy; architect-designed buildings; and civil engineering projects, including bridges and tunnels.

SERVICES

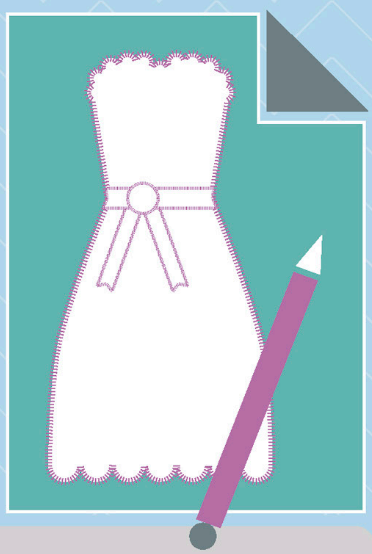
Job production can also apply to services, such as hairdressing or processing an order for pickup. Airline flights come under the same umbrella—flight attendants tailor their services to passengers' dietary requirements and special needs for such items as wheelchairs.

Wedding dress production

A bride-to-be can choose to buy a dress off the rack (typically made by batch production) or have one specially designed and made for her, which costs significantly more.

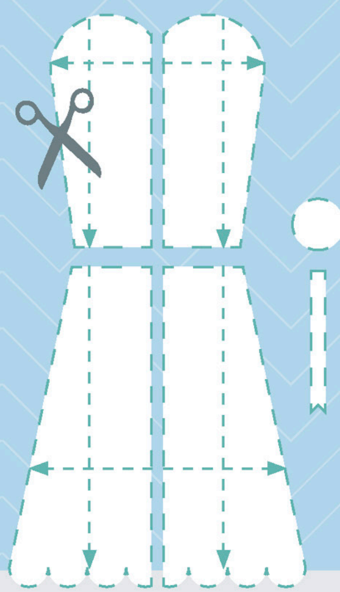
Bride-to-be at the store

The bride cannot find the dress of her dreams and opts to pay for a custom garment.



Dressmaker commissioned

A dressmaker is hired to design a wedding dress to the bride-to-be's specifications.



Cutting out the dress

The dressmaker makes a pattern and cuts one dress from the bride-to-be's chosen fabric.

JOB PRODUCTION PROS AND CONS

Pros

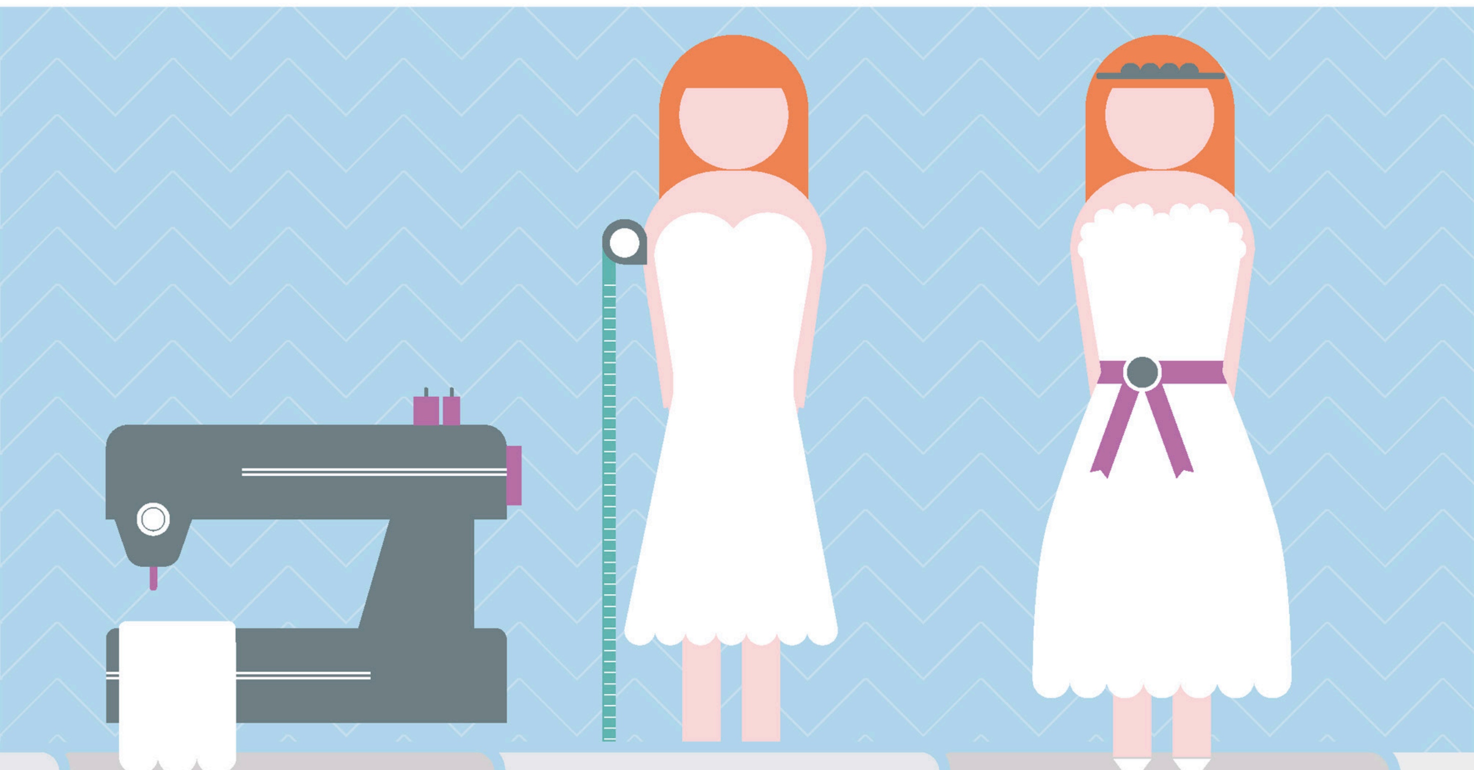
- Products generally of high quality
- Great job satisfaction and pride in work followed through from start to finish
- Producer can satisfy individual customer needs
- Can make a profit with only a few customers
- For small jobs, word-of-mouth recommendations reduce marketing costs

Cons

- Does not allow for economies of scale, so high production costs
- Labor-intensive
- Special materials and investment in skills may be required
- High price may put off customers, especially in times of recession
- Heavy reliance on just a handful of customers

$1,600

the average cost of a wedding dress in the U.S. in 2019



Sewing the dress
The dressmaker focuses on stitching and finishing this single garment.

Dress fitting
After any alterations, the dressmaker is satisfied that the dress fits the bride-to-be and meets her requirements.

Completing the dress
The price is high, but the dress is exactly what the bride-to-be wants. Now, the dressmaker can start on another dress.

Batch production

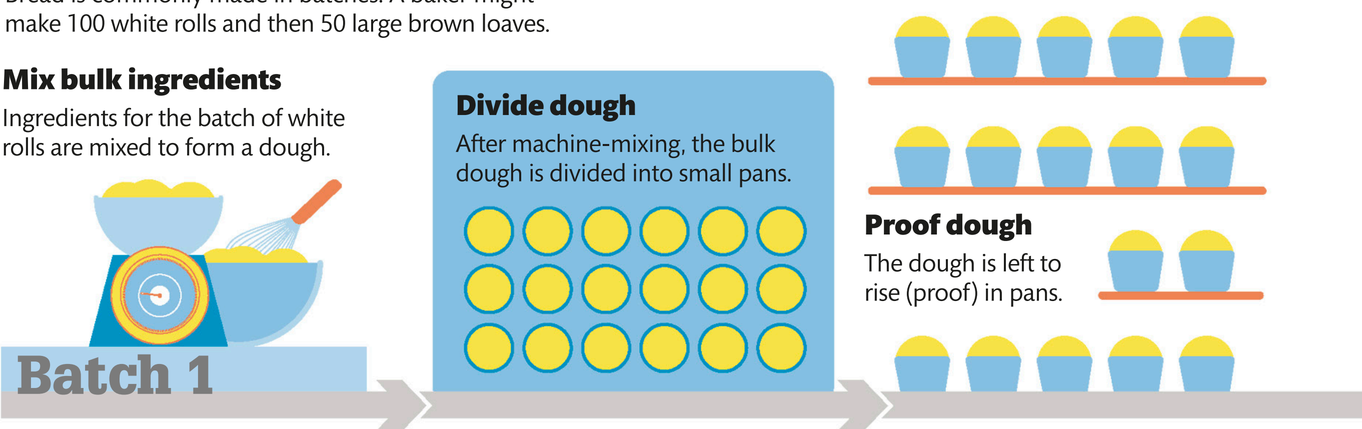
When a number of the same items are made together, it is called batch production. One batch finishes each stage of the production process before the next begins, using the same equipment and steps.

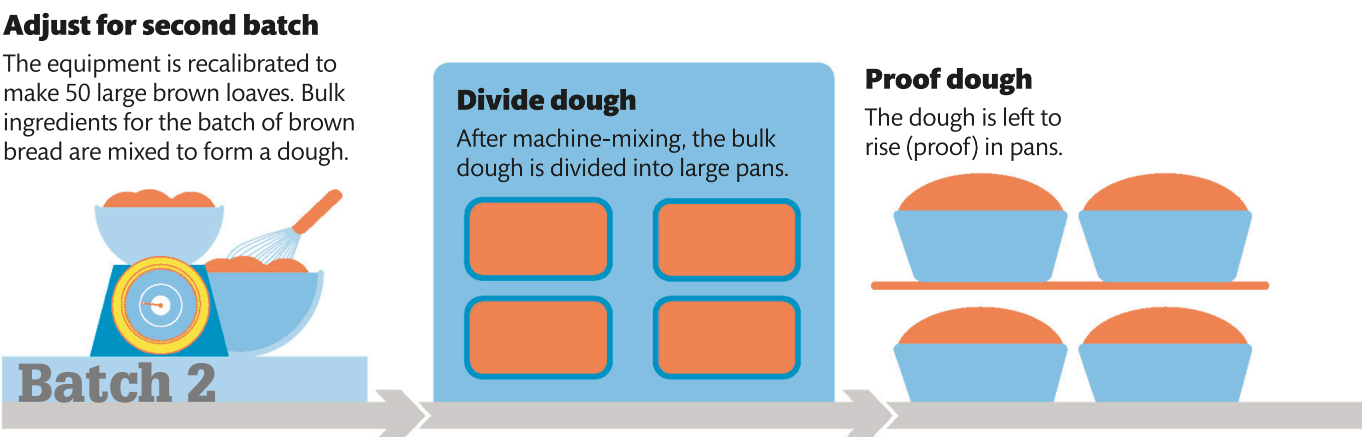
How it works

Batch production allows a firm to make a quantity of items in one production run. Factory equipment is geared up in terms of scale and special tools that can be changed for each batch. For example, equipment is set up to make 200 size 8 dresses in red fabric and then adjusted to produce 400 size 10 dresses in blue fabric. Quantities can vary from as few as four identical items for a local supplier to thousands for a department store, and batches can be made as often as required. Batch production is common in the food, clothing, footwear, paints, adhesive, and pharmaceutical ingredients industries. Each batch must be traceable, with clear date stamping, in order to comply with laws and standards.

Bread by the batch

Bread is commonly made in batches. A baker might make 100 white rolls and then 50 large brown loaves.





53 loaves

Average bread eaten yearly per person in the US

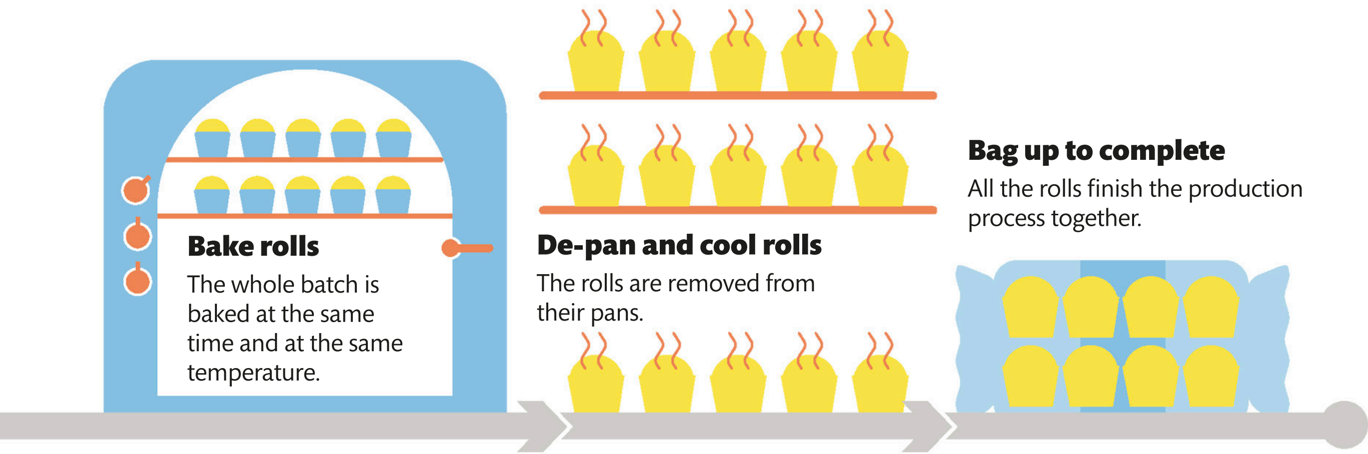
BATCH PRODUCTION PROS AND CONS

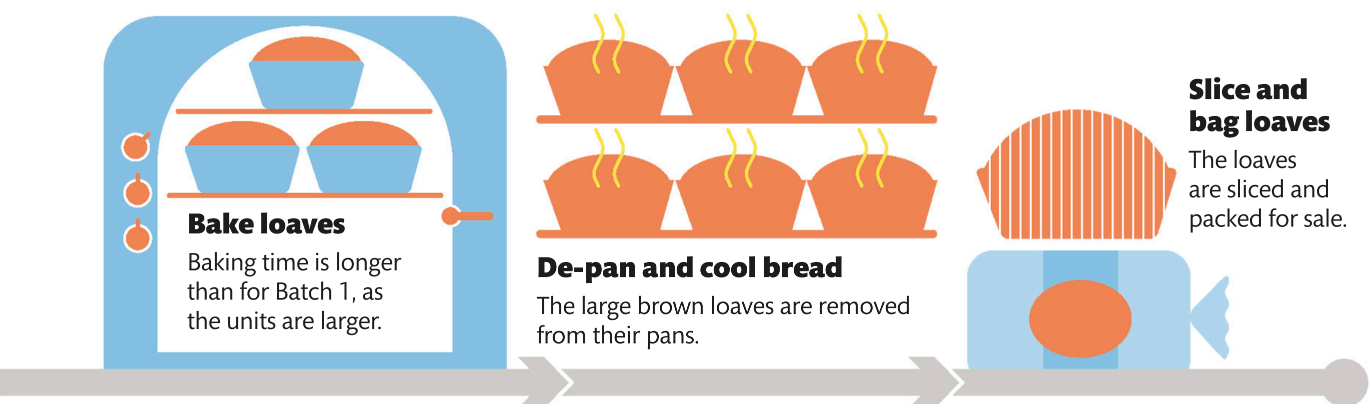
Pros

- Economies of scale: low unit costs, as large number is made
- Customer offered choice of, for example, size, weight, and flavor
- Output and productivity increases with use of specialty/dedicated machinery

Cons

- Repetitive work (even if automated), so workers may be less motivated
- Costly because may require storage of raw materials, work in progress, and finished items (*see p.139*)
- Requires detailed planning and scheduling





Flow production

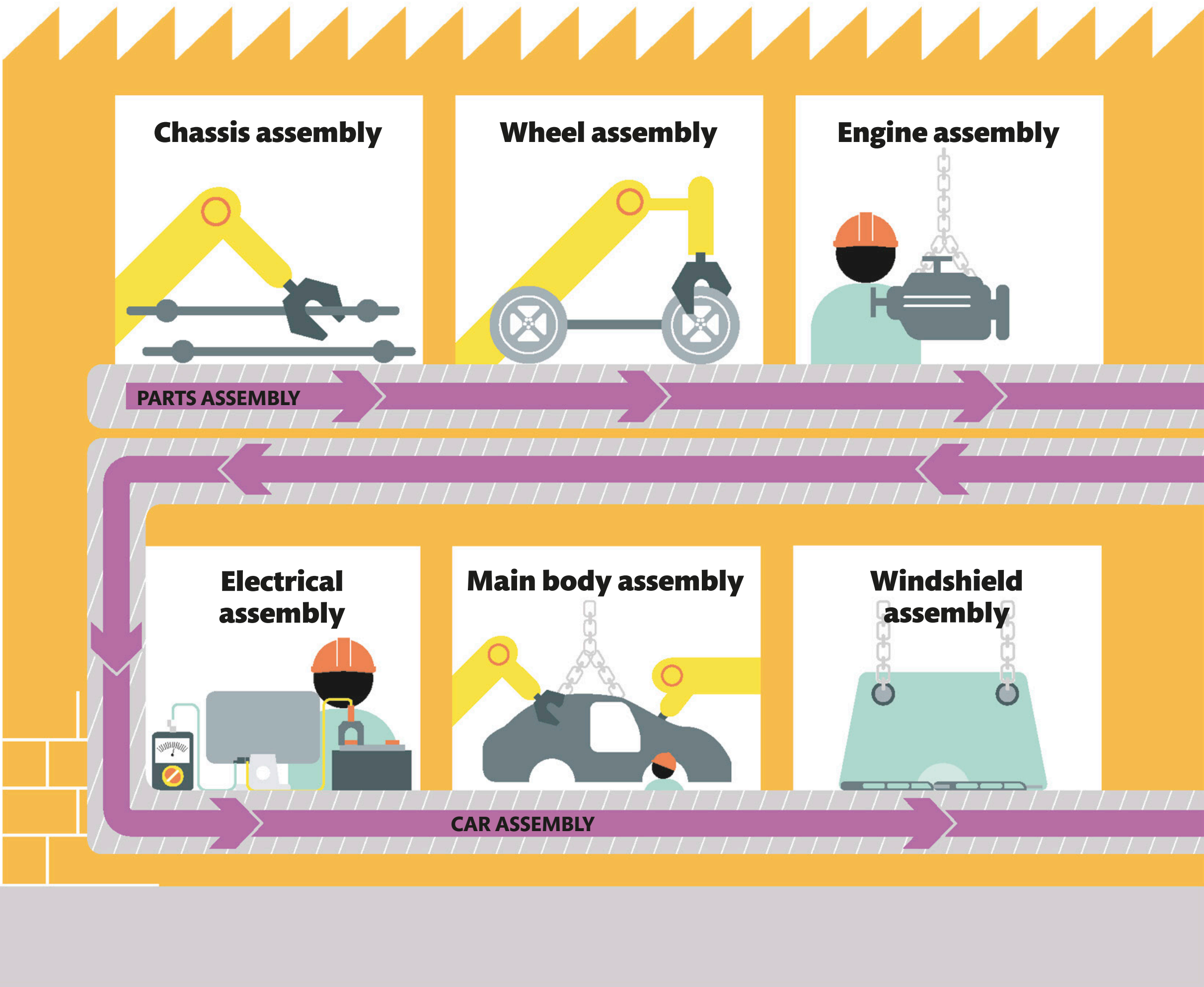
The purpose of flow (mass) production is to produce a large number of identical, standardized items. This usually happens on a moving line, which can be interrupted when the product is changed.

How it works

Flow production typically involves large factories equipped with conveyor belts and expensive machinery; the assembly of individual components, which may be brought in from other companies; and the automation of tasks. Car manufacturing is an example where elements of the car are put together along a line; robot arms may install wheels, and workers may perform specialized jobs. Significant output is possible with even a small number of workers. Newspaper printers, oil refineries, and chemical plants also use flow production.

The production line

In flow production, the item being made, such as a car, moves on a conveyor belt through different stages until completion. Components to build the car may have been outsourced or produced in another of the company's factories. They are all ready to be used along the line.

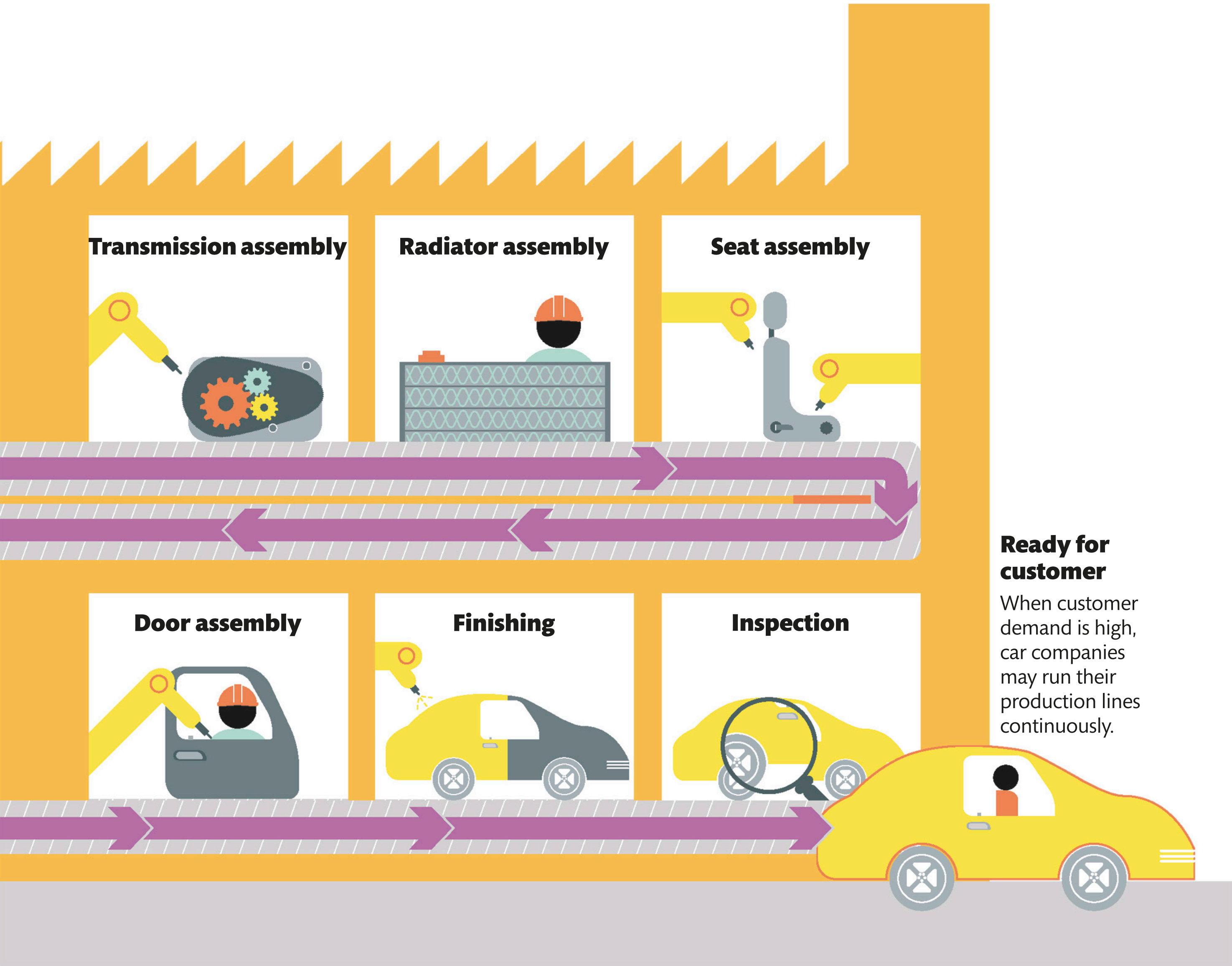


FLOW PRODUCTION PROS AND CONS

Pros	*Cons*
Economies of scale: can produce large number of goods cheaply	Expensive machinery requires significant investment
Unskilled labor and automation keep costs low	Repetitive work means workers may be less motivated
Materials bought in large quantities, so low cost	Reliant on equipment: if line breaks, production is halted

78 million

vehicles were produced globally in 2020



Ready for customer

When customer demand is high, car companies may run their production lines continuously.

Mass customization

Sophisticated technology and manufacturing developments allow mass products to be personalized. The low unit cost of mass production pairts with the marketing opportunities of custom-made.

How it works

Mass customization offers new opportunities for the manufacturing and service industries. Social media, online technology, 3-D modeling tools, e-commerce software, and flexible production systems and processes are allowing customers to configure products to match their own tastes and needs. Industries such as footwear (particularly athletic shoes), clothing, cars, jewelry, and computers already allow consumers to customize their purchases. The price is generally higher than for standardized goods.

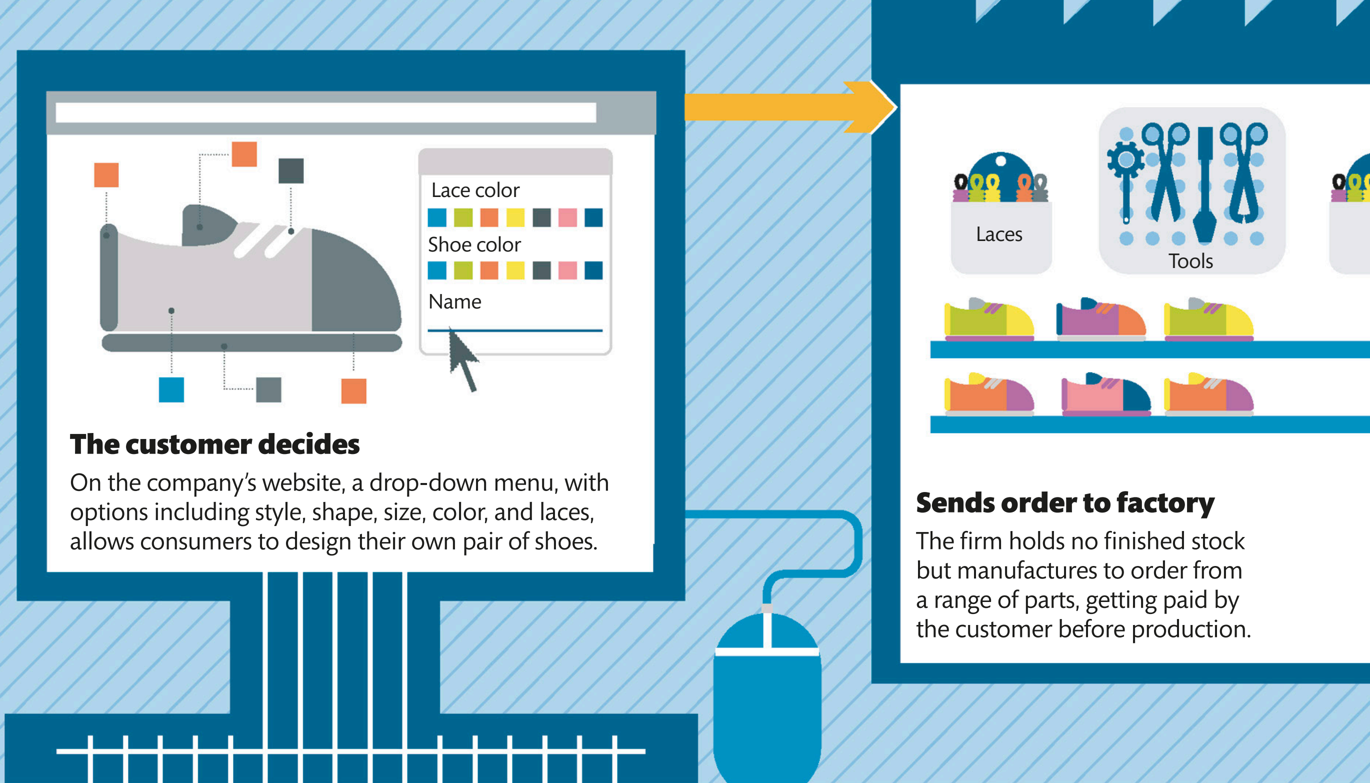
Revolutionary new technologies are expected to further extend customization, allowing individuals to, for example, scan their body contours and use augmented reality to design and order unique clothing.

FOOD MIXES

The generation raised on social media expects to personalize every aspect of their lives, and food and drink are set to be a growth area for mass customization. Websites allow consumers to make their own cereal mixes, which is especially useful for those with allergies, and to create their own blends of tea and coffee.

Customers design own products

Mass customization has enormous potential to change consumerism. For example, consumers can buy shoes designed to their own specification via the Internet. This is a high-status commodity among certain groups.



The customer decides

On the company's website, a drop-down menu, with options including style, shape, size, color, and laces, allows consumers to design their own pair of shoes.

Sends order to factory

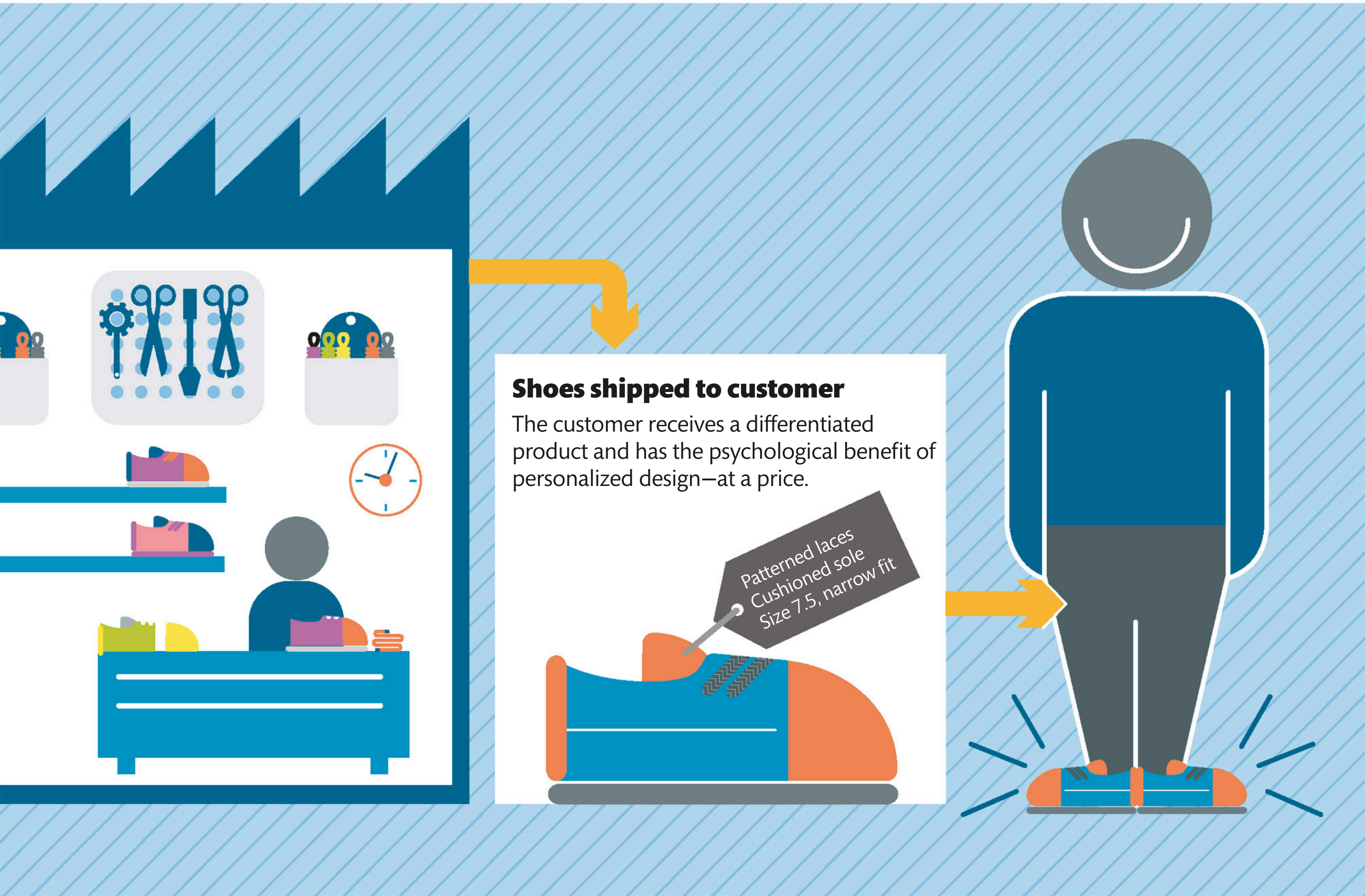
The firm holds no finished stock but manufactures to order from a range of parts, getting paid by the customer before production.

25.3%
the average amount more that consumers are willing to pay for personalization

FOUR TYPES OF MASS CUSTOMIZATION

In his book *Mass Customization: The New Frontier in Business Competition*, B. Joseph Pine II outlines four distinct types:

- **Collaborative customization** Work with individual customer to develop specific product to suit their needs. Technology firms, for example, assemble computers to customer's specification.
- **Adaptive customization** Produce standardized products that are customizable by end user. For instance, U.S. company Lutron produces a lighting system that lets customers choose settings from preprogrammed options.
- **Transparent customization** Provide unique products to individuals without overtly stating that items are customized. Many hotel groups, for instance, keep a database of guests' preferences to help personalize their stay.
- **Cosmetic customization** Make a standardized product, but market it differently. Branded bags, T-shirts, and pens used to promote a business are examples.



Shoes shipped to customer
The customer receives a differentiated product and has the psychological benefit of personalized design—at a price.

Continuous production

During continuous production, a product is made 24 hours a day, seven days a week. The production line runs continuously to keep up with demand, and staff work around the clock in shifts.

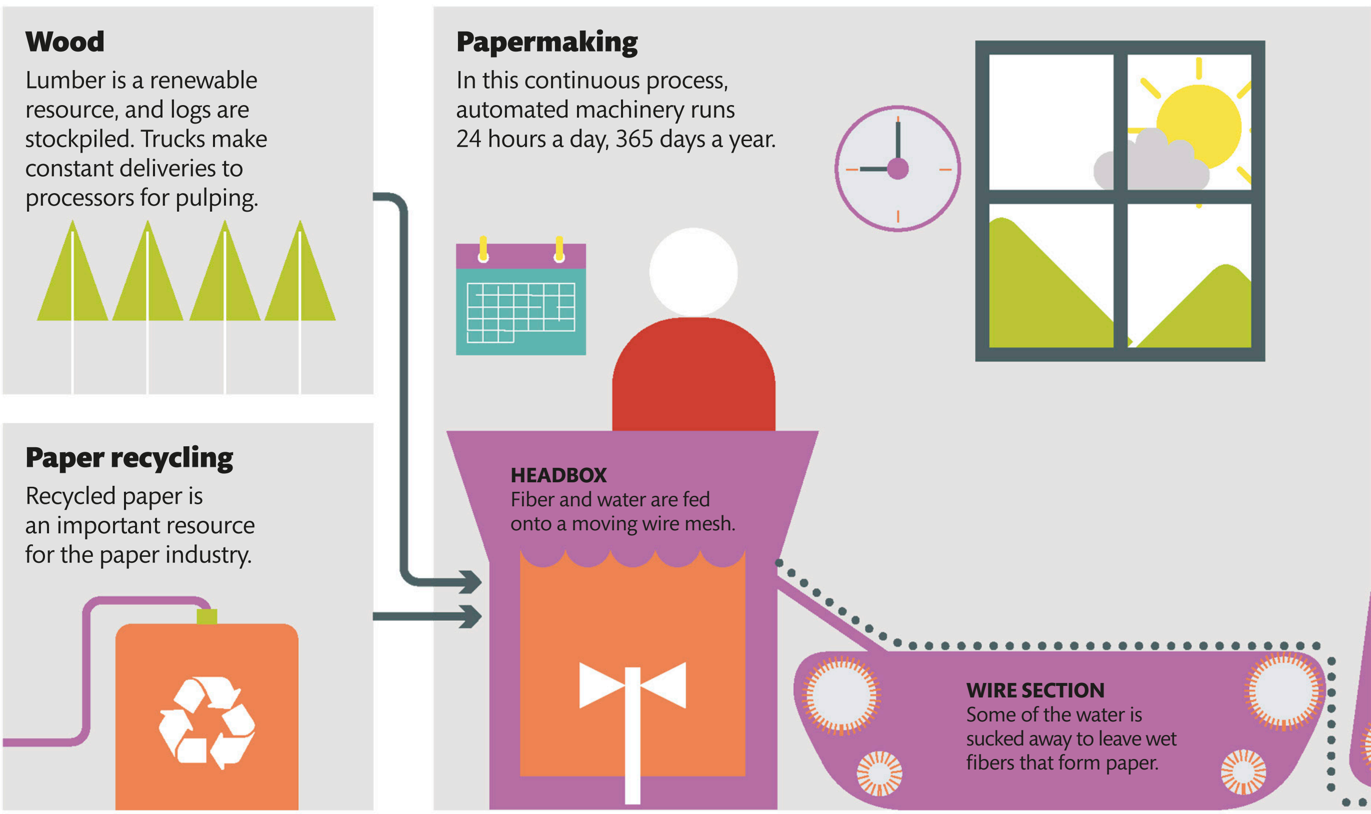
How it works

With flow or mass production, the line is stopped to change products or models. Continuous production uses the same concept, but it runs throughout the year, so output is nonstop. This method is used for identical commodities with high, consistent demand, including paper, cardboard, packaging, laundry detergent, electronic components, and oil products. As with mass production, processes are automated, staffing levels are kept to a minimum, and quality control is essential.

There is high competition in industries using continuous production. Margins may be low, but demand is often relatively stable, encouraging investment in capital equipment.

The paper trail

Paper is used throughout the world, and factories operate 365 days a year to satisfy constant demand. Lumber is the raw material for papermaking. Once the lumber has been debarked, chipped, and pulped, the fibers are washed and dyed. At the end of its life cycle, some paper is recycled.

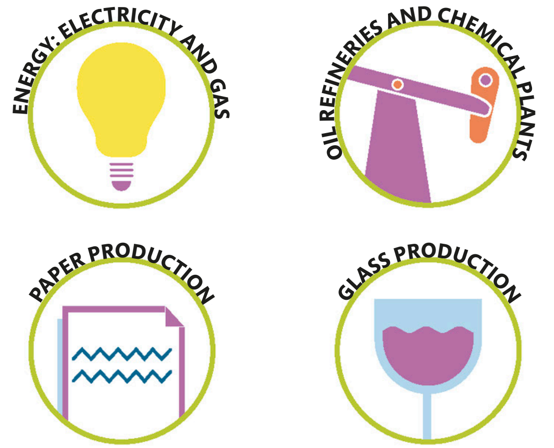


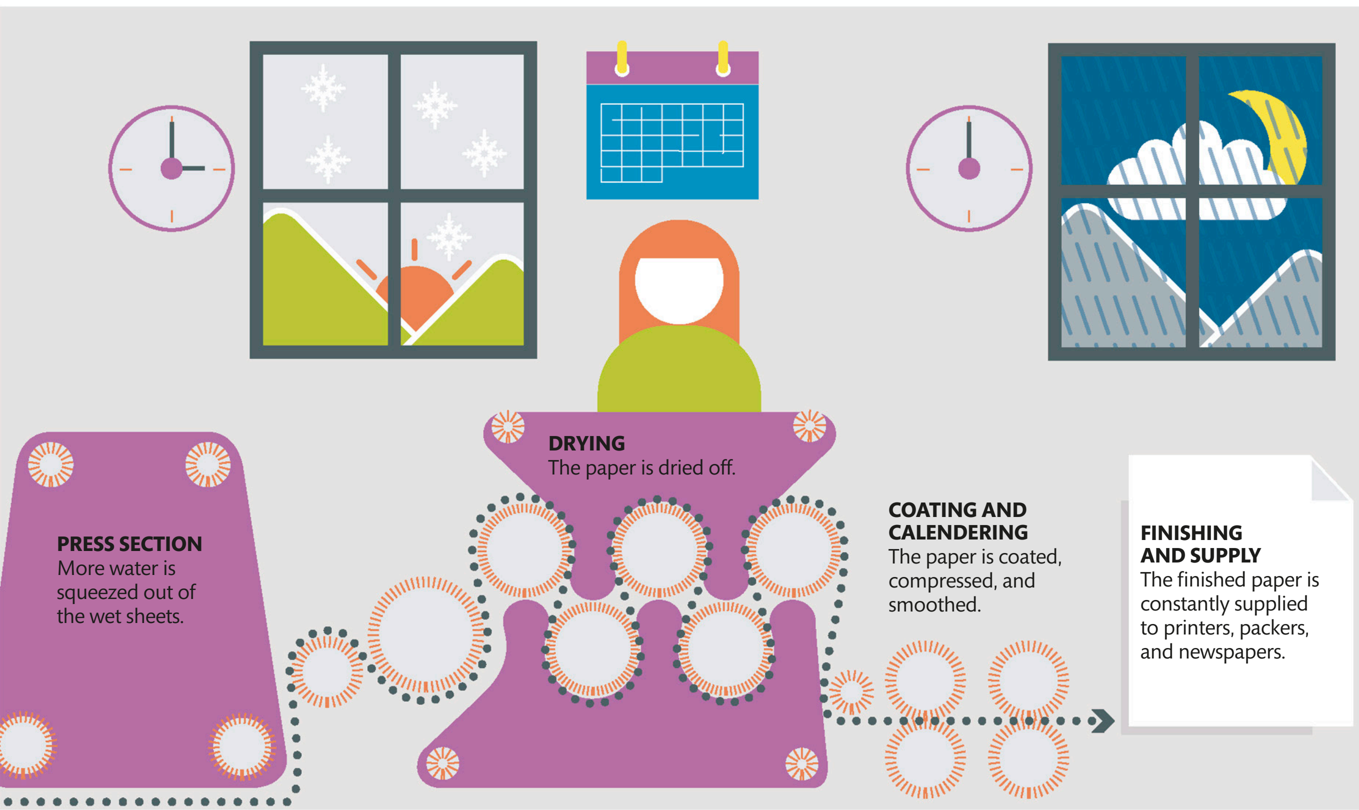
121 lbs.

of paper is used on average by every person on the planet each year

TYPICAL USES

Continuous production is used for undifferentiated commodities required in large and constant amounts.





Hybrid processes

Manufacturing firms may adapt existing processes or combine two production methods for optimal performance, particularly if they make a wide range of products.

How it works

There are many examples of hybrid processes. One is linked batch flow production, where only two or three pieces of equipment are required and a batch flows from one process to another. This is common in the chemicals and pharmaceuticals industries. For instance, a company may make headache medication and a hay fever remedy in tablet, capsule, and liquid form and in varying doses; each batch flows through a series of steps, depending on composition and form, from bulk processing to packaging. Another example is cell manufacturing, which combines job production with flow (mass) production.

NEED TO KNOW

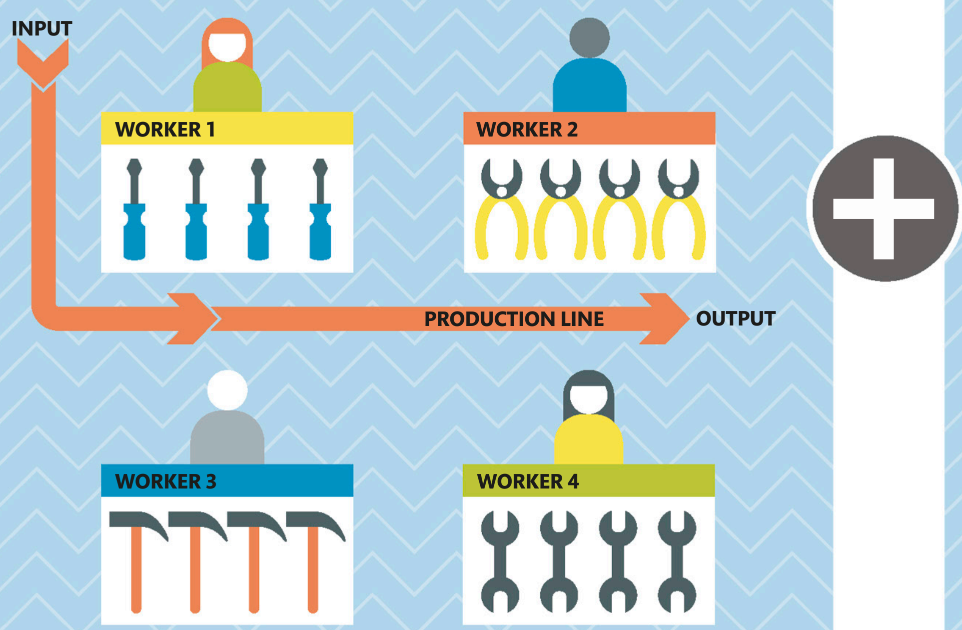
- **Increments** Small steps of gradual improvement over a period of time rather than breakthrough or transformational change
- **Hybridization** Replacing several separate processes with one single hybrid process

Combining methods

On the classic assembly line, each worker is skilled at producing one type or part of an item. At the other end of the scale, one person completes all stages, creating the finished product from beginning to end. Cell manufacturing combines flow production with job production to create autonomous units. A number of workers are dedicated to production, or partial production, of a set of goods.

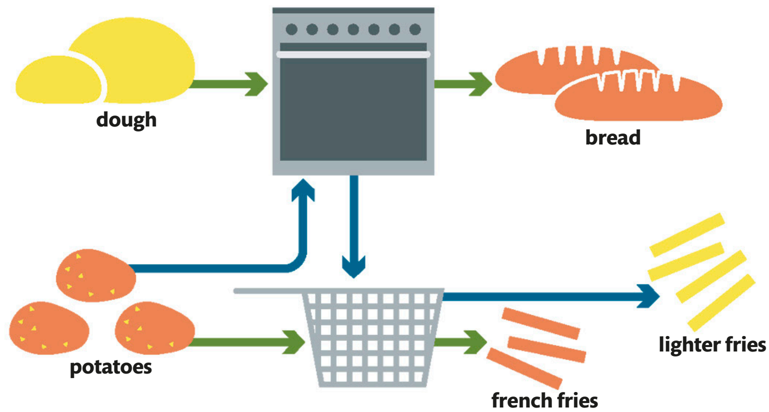
Flow production

One process is handled by one or more workers, and that job is completed before the product or part moves on to the next workstation. Worker 1 uses only one set of tools for the process before the product moves on to Worker 2, and so on down the line. *See pp.276–277.*



HYBRID PROCESSES FOR INNOVATION

By combining manufacturing processes, companies can create products with new and original qualities. For instance, a food company that makes bread and french fries may speed up production of the fries by baking them in the bread oven first. This has the unintended but beneficial consequence of making the fries healthier. A new product is created, which may now be marketed as a new proposition to a different set of consumers.

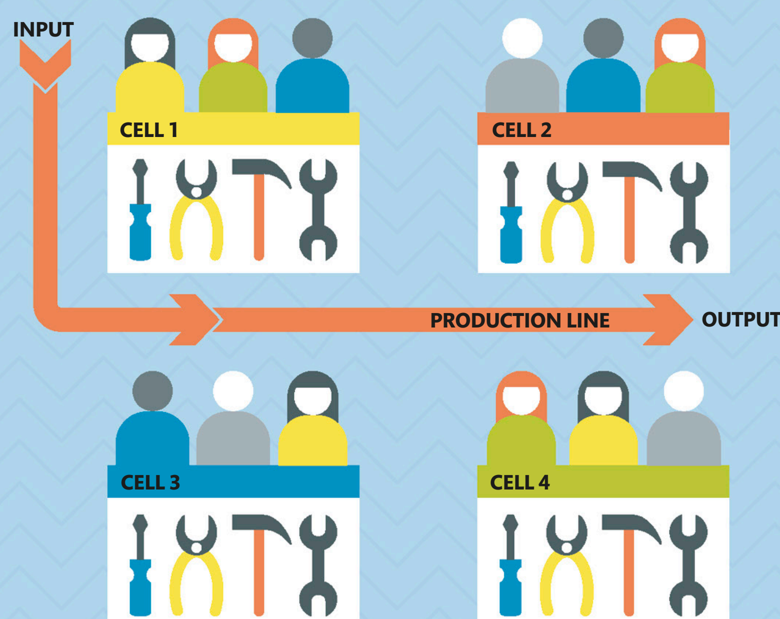


Job production

One worker creates a one-of-a-kind product, such as a custom kitchen, from start to finish. This way of working can be more rewarding for the worker, who uses a range of skills, but it tends to be costly for the customer. *See pp.272–273.*

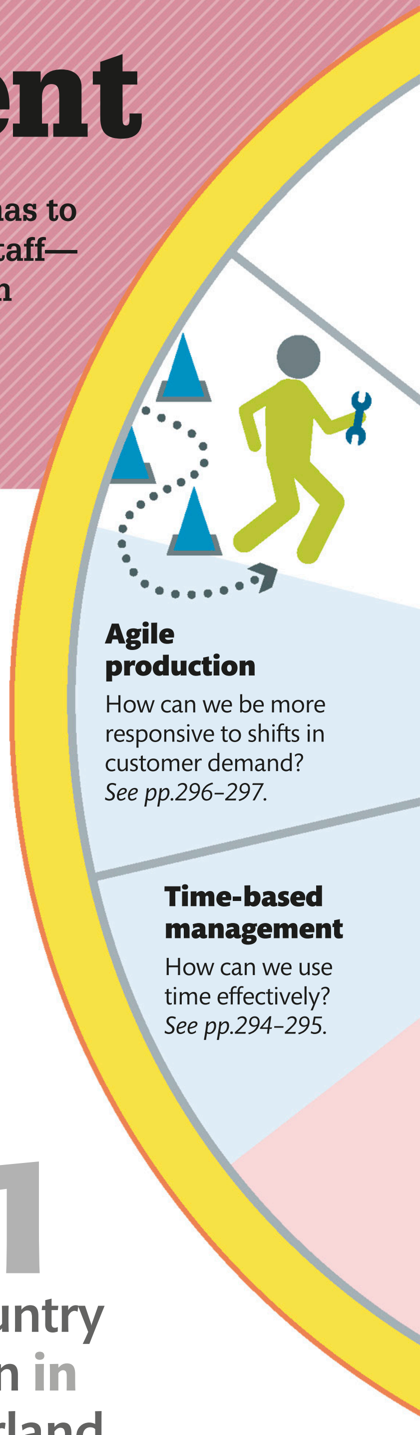
Cell manufacturing

Combining the best of flow and job production, here a group of products or parts is produced in separate small units (cells) made up of a number of workers in the factory. Workers are trained to produce all the items in the set. Dissimilar items can be produced without slowing the production line. The idea is to improve performance by giving each cell a degree of autonomy.



Management

Every manager in a business, particularly in manufacturing, has to ensure that all resources—from materials to equipment and staff—are used efficiently, while keeping the customer continually in mind. Managers make key decisions to lay down procedures and set standards and then work continuously to improve processes to ensure that the company remains profitable.



Which approach?

How people and processes are organized in making and delivering the product to the customer is critical if a company is to survive fierce competition and rapidly shifting consumer demands in a global market. In making decisions about how a business can meet its goals, managers may combine a number of approaches, as many are interlinked and achieve similar outcomes.

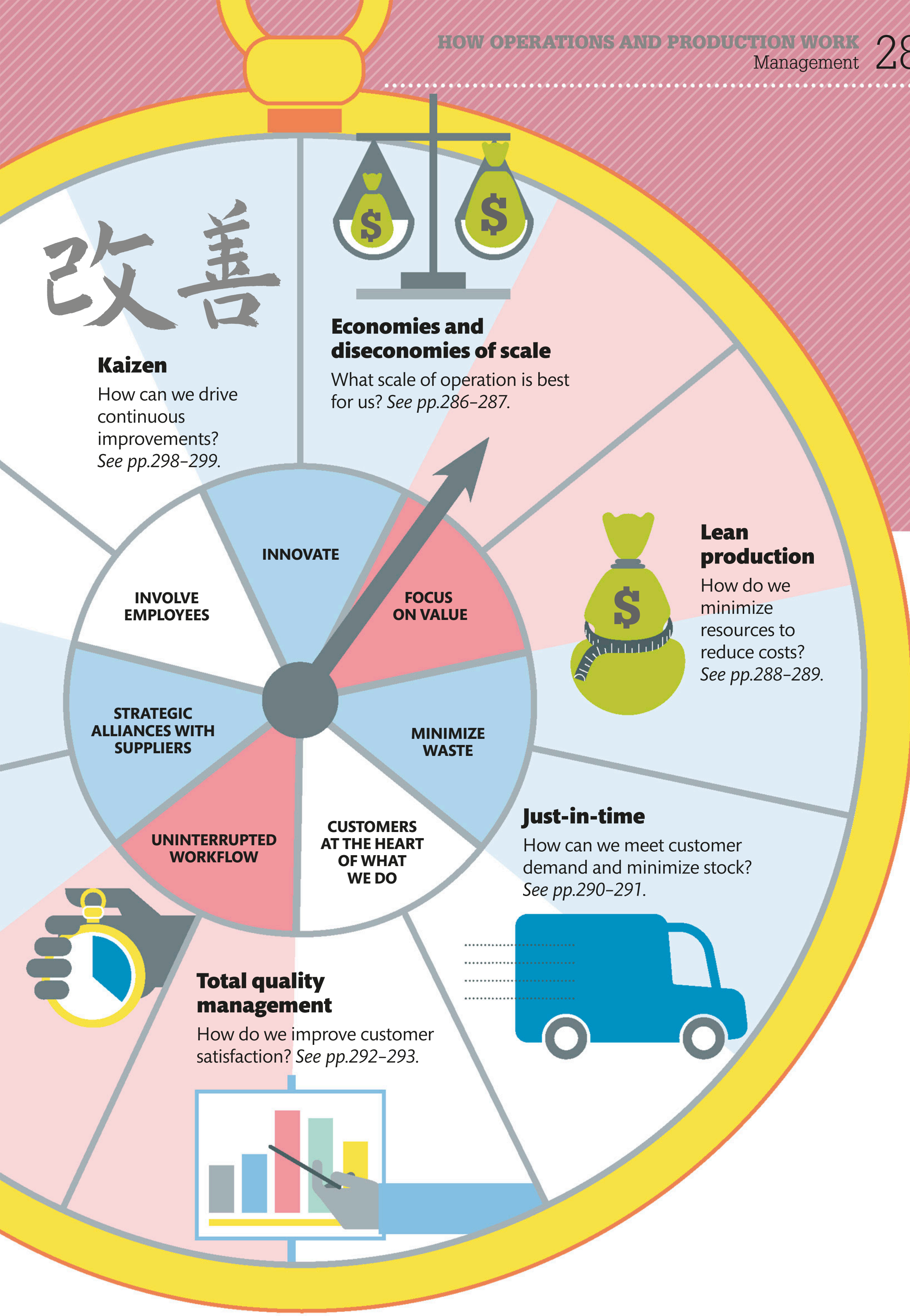
MANAGER OR LEADER?

Management and leadership are not the same but are closely linked:

- Managers **plan**, **organize**, **coordinate**, **ask questions**, and **motivate**; leaders also **create a vision** and **inspire**.
- Managers organize workers to **maximize efficiency** and **nurture skills**; leaders also **develop future talent**.
- Managers focus on the **bottom line**; leaders also **look to the future**.
- Managers explain to workers what **needs to be done** and **provide the support to do it**; leaders also persuade workers to **want to do more** than needs to be done.
- Good managers **require leadership skills**; great leaders **know what it takes** to be good managers.

The following classic distinction has been attributed to two different business leaders and writers, Peter Drucker and Warren Bennis: management is doing things right; leadership is doing the right things.

No.1
European country for innovation in 2020: Switzerland


改善
Kaizen
How can we drive continuous improvements? See pp.298–299.
Economies and diseconomies of scale
What scale of operation is best for us? See pp.286–287.
Lean production
How do we minimize resources to reduce costs? See pp.288–289.
Just-in-time
How can we meet customer demand and minimize stock? See pp.290–291.
Total quality management
How do we improve customer satisfaction? See pp.292–293.
INNOVATE
FOCUS ON VALUE
MINIMIZE WASTE
CUSTOMERS AT THE HEART OF WHAT WE DO
UNINTERRUPTED WORKFLOW
STRATEGIC ALLIANCES WITH SUPPLIERS
INVOLVE EMPLOYEES
$
$
$

Economies and diseconomies of scale

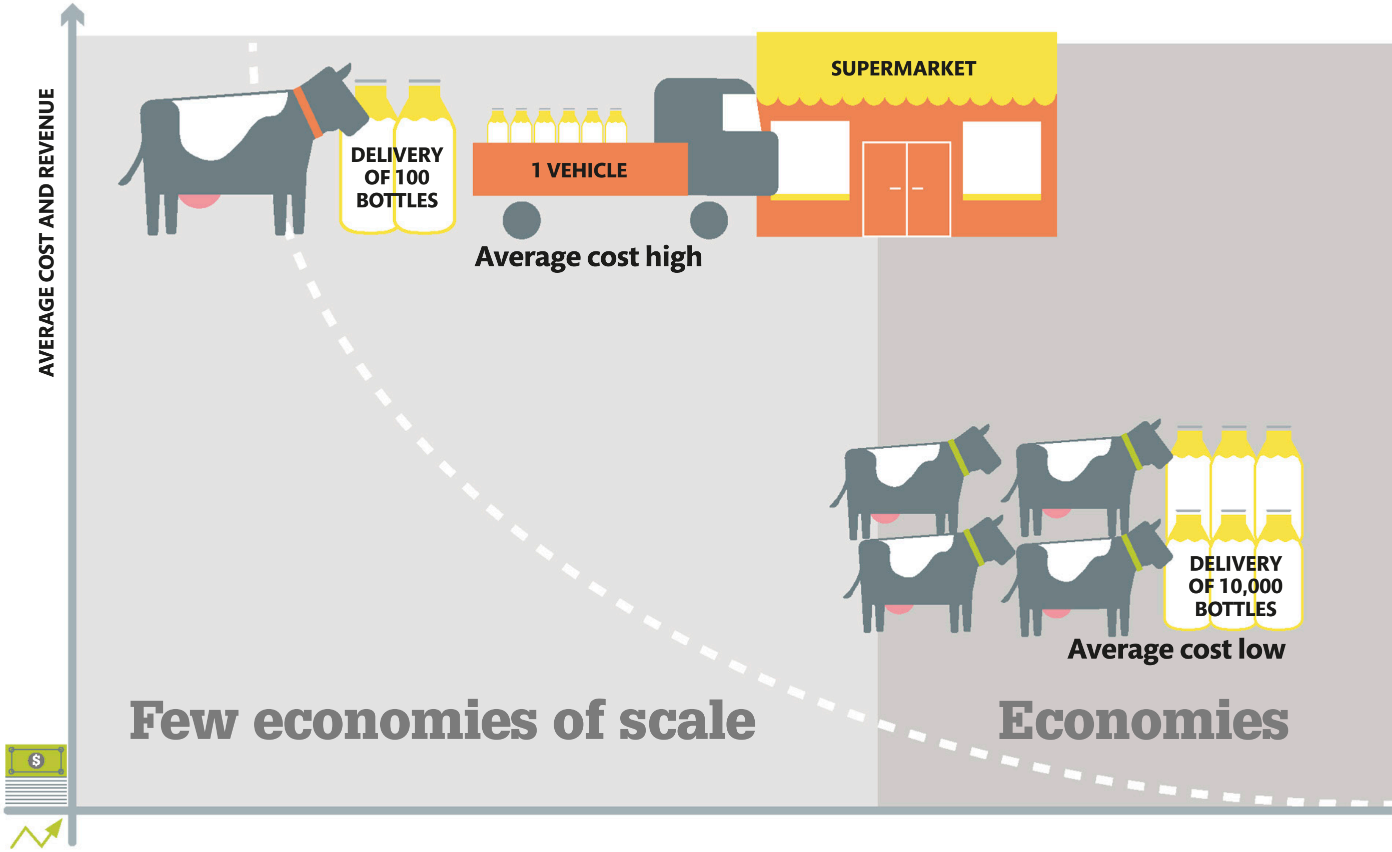
Economies of scale are one of the advantages of large-scale production, yielding a lower unit cost of each item produced. However, costs can also go up as the operation grows, resulting in diseconomies of scale.

How it works

Economies of scale is a simple concept: the more items produced or handled, the cheaper the average (unit) cost, as efficiencies and fixed costs are shared across all items. This gives a business a competitive advantage. Supermarkets, for example, buy food in bulk at low unit costs, which they pass on to consumers. However, diseconomies of scale may occur when the operation experiences high administration costs, waste from lack of control, or lack of employee productivity.

Economies of scale

While it may be inefficient for a small dairy to supply milk to a supermarket, it is cost-effective for a large dairy operation producing thousands of bottles. If a delivery is too large, though, waste can creep in due to associated costs.

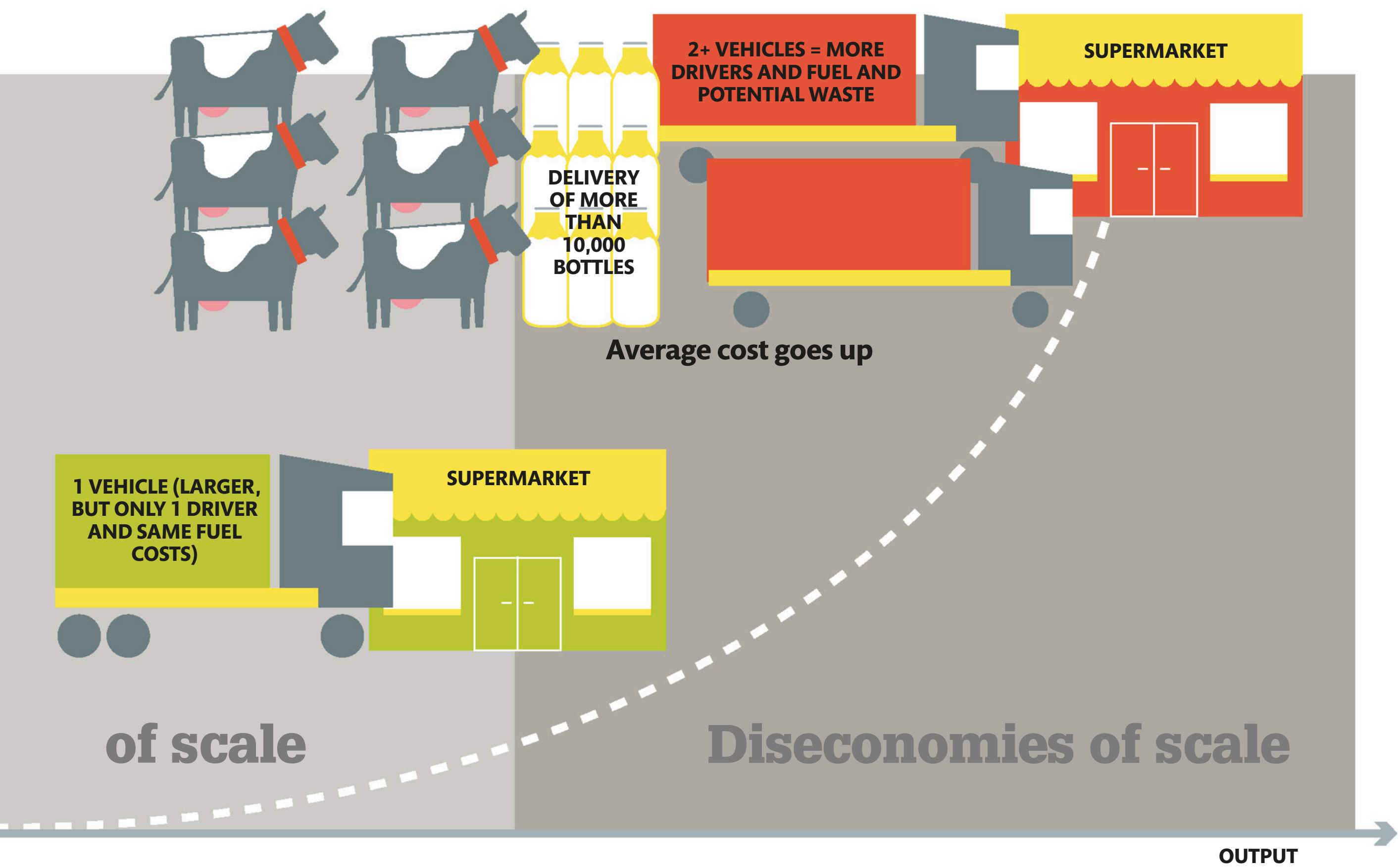


NETWORK ECONOMY

Online networks, such as eBay and Facebook, rarely stray into diseconomies of scale. They can deliver economies of scale even at an international level: the cost of adding one more user to a network is almost zero. However, the resulting benefits may be huge, because each new user in the network can interact or trade with other members of the network.

9%

higher net profit at Netflix in 2020 compared with 2016 after adding 115 million more subscribers



Lean production

The goal of lean production is to reduce the resources used to supply goods and services to consumers. By cutting human effort, materials, space, capital, and time, lean production cuts costs.

How it works

The focus in lean production is on efficiency to maximize value for the customer but not affect quality. Lean seeks to eliminate all activities that do not add value to the production process, including holding inventory (stock), repairing faults, and unnecessarily moving people and products around a manufacturing plant.

Optimizing the flow of products and services through value streams—which are sequences of activity that flow horizontally across technologies, assets, and functions to customers—allows the business to respond more quickly to consumer demand. Efficiency also makes it simpler and more accurate to manage information.

NEED TO KNOW

- **Kanban cards** Toyota's demand-driven scheduling triggers
- **Value-stream mapping** The process of analyzing how the product gets from start to finish now and the design of an improved flow for the future

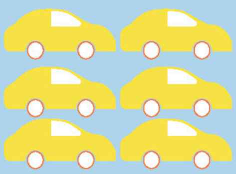
Case study: how Toyota eliminates waste

Lean production is about getting rid of waste, sometimes called non-value-added activities. Car manufacturer Toyota has identified eight areas of waste and a lean approach to counter these.

Overproduction

Waste

Items produced beyond customer demand



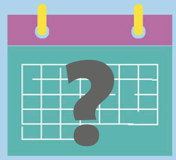
Lean solution

Manufacture based upon a pull system, producing products as customers order them

Waiting

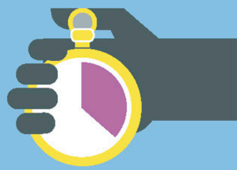
Waste

Unproductive time spent waiting for material, information, equipment, tools



Lean solution

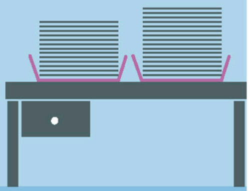
All resources provided on a just-in-time (JIT) basis—not too early, not too late (*see pp.290–291*)



Excess inventory

Waste

Extra, unwanted stock held in inventory



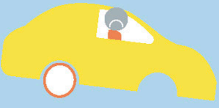
Lean solution

Kanban cards used to indicate material order points: how much, from where, and to where

Defects

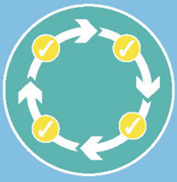
Waste

Consumes materials and uses up labor; results in customer complaints



Lean solution

Total quality management (*see pp.292–293*) used to improve all areas



CREATING A LEAN COMPANY

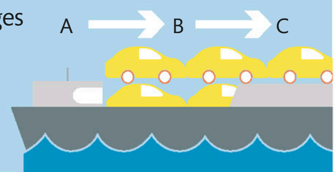
In their 1996 book, *Lean Thinking: Banish Waste and Create Wealth in Your Corporation*, James Womack and Daniel Jones identify the five principles of lean manufacturing:

- **Value** Use surveys, interviews, analytics, and other sources to define customer value—what customers really want from your products and what they are willing to pay.
- **Value stream** Map the value stream by determining all company activities that contribute to creating customer value. Those that do not may still be necessary to the business, but anything else should be eliminated.
- **Flow** Make sure all the remaining steps run smoothly together, without disruption.
- **Pull** Implement a "pull system," so work only occurs when there is actual demand. Make sure the necessary materials and information are available to create the right quantity of products at the right time, cutting labor, resources, and storage waste.
- **Perfection** Make the process of continuous improvement part of the organization's culture, and keep trying to get better every day.

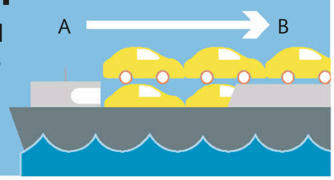
9.5 million
the number of cars Toyota sold in 2020

Transportation in stages

Waste
Superfluous stages in the transportation process

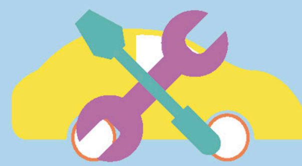


Lean solution
Material shipped directly from the vendor to the assembly line

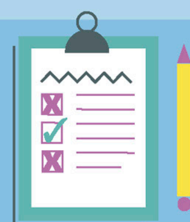


Non-value-added processing

Waste
Unprofitable stages in the production or reworking of a product

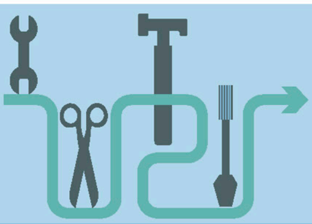


Lean solution
Map the value stream to identify non-value-added steps in the process; get it right the first time

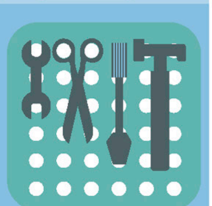


Excess motion

Waste
Poor workflow, poor layout, and inconsistent working methods

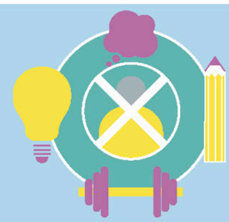


Lean solution
Workplace Organization, a systematic method for standardizing the workplace



Underused people

Waste
Underutilization of employees' mental, creative, and physical skills and abilities



Lean solution
Work cells replace assembly line; better use of labor and employee involvement

Just-in-time

The system of production in which an actual order is the trigger for an item to be manufactured is called just-in-time. It enables a firm to produce only required items, in the right amount, at the right time.

How it works

Also called demand-pull production, just-in-time means that stock levels of raw materials, components, work in progress, and finished goods are kept as low as possible, reducing costs. The system requires detailed planning, scheduling, and flow of resources throughout the production process, now assisted by sophisticated production-scheduling software. Supplies have to be delivered directly to the production line when they are needed, requiring strong relationships and interconnected systems with suppliers. The benefits of reduced inventory are balanced against the cost of frequent deliveries and loss of purchasing economies of scale (discounts for bulk buying). The system dates back to 1953, the year Toyota brought in just-in-time manufacturing. The phrase is sometimes used in a more general sense today to mean eliminating waste of resources.

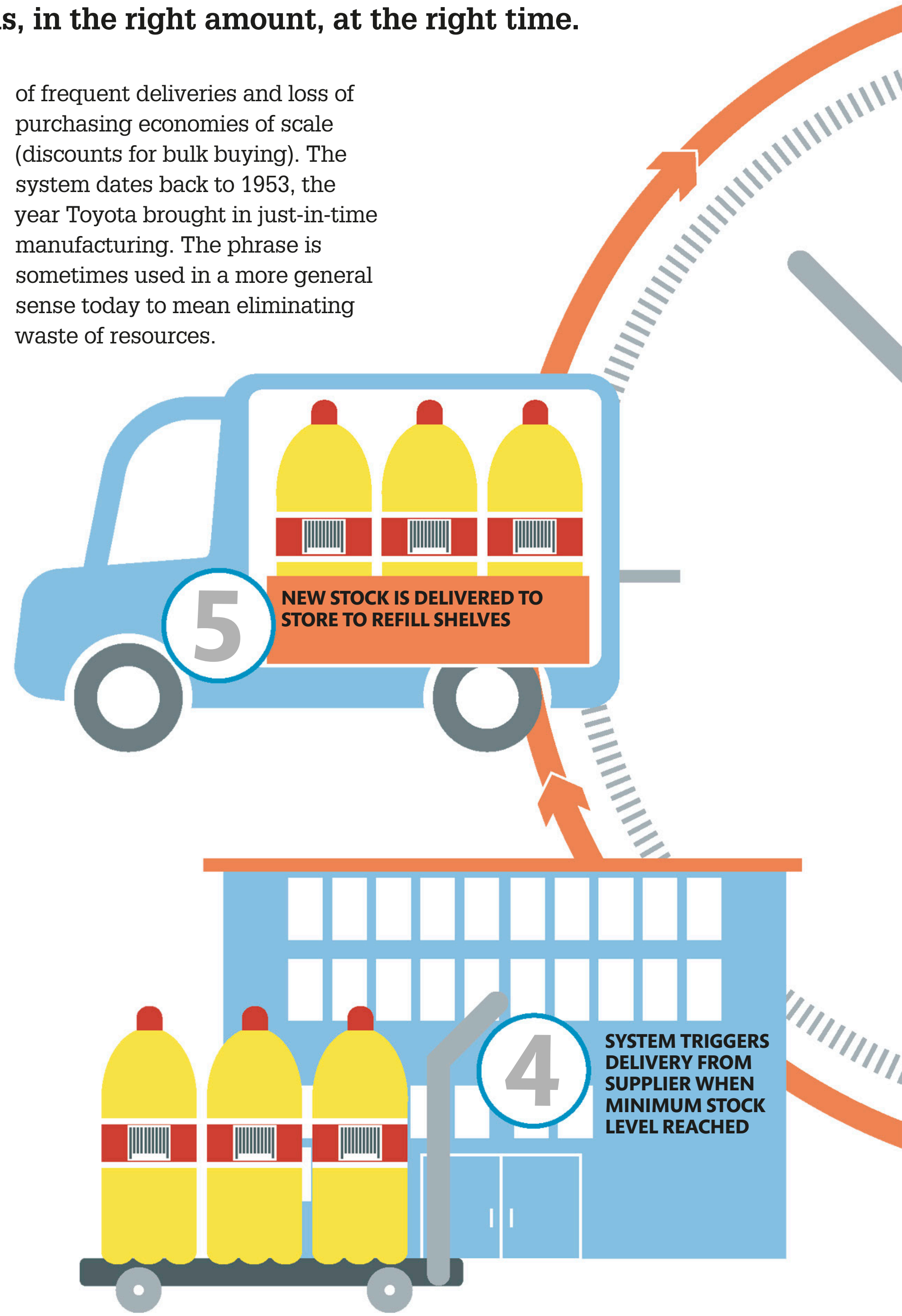
JUST-IN-TIME PROS AND CONS

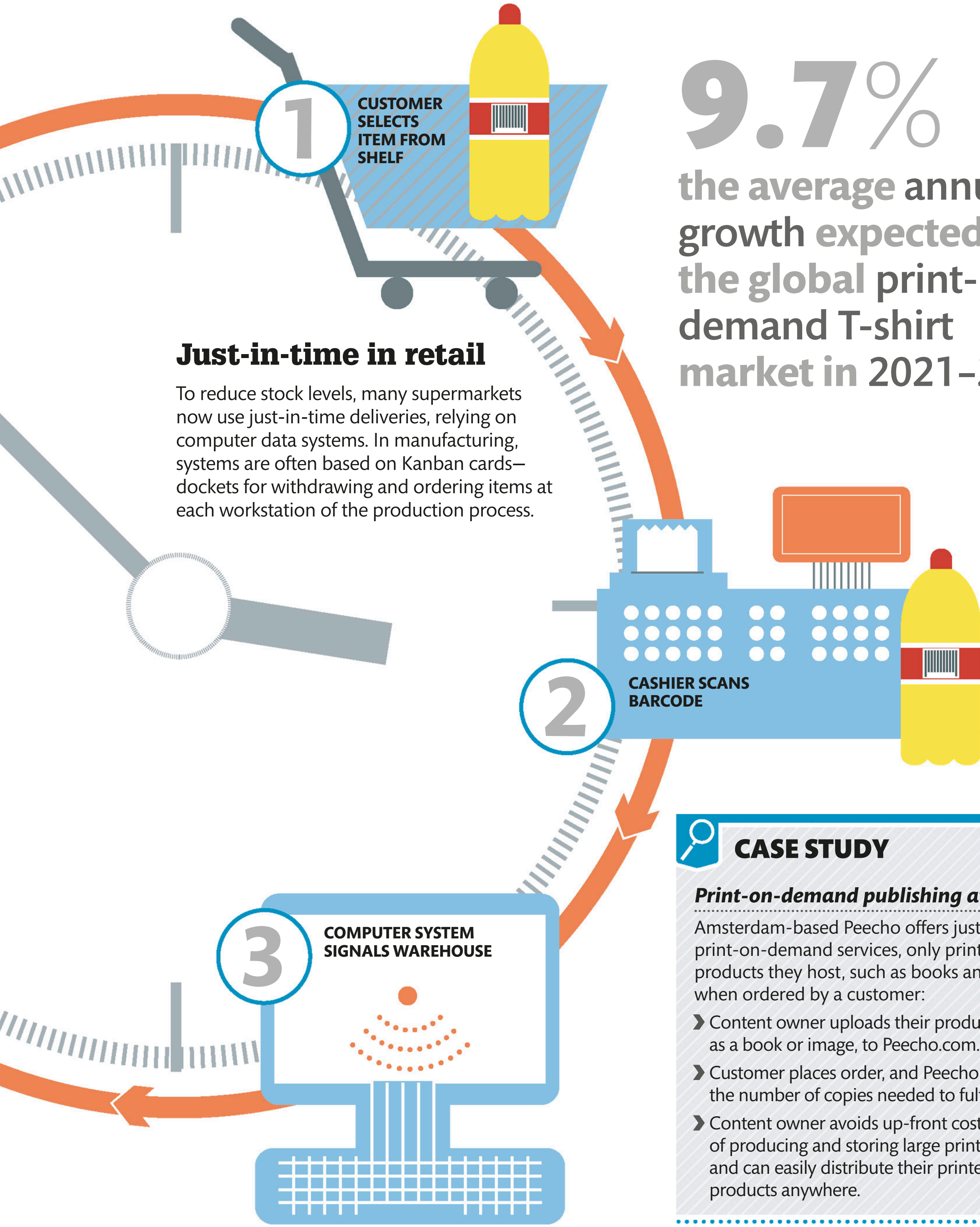
Pros

- **Lower stock** so less storage space and less working capital needed
- **Demand-pull** avoids obsolete, out-of-date stock
- **Staff** spend less time checking and moving items

Cons

- **No room for error**—for instance, if there are any faults in the stock delivered, the whole day's production is halted
- **Operation** is reliant on suppliers
- **No cushion** for sudden upsurge in demand





Just-in-time in retail

To reduce stock levels, many supermarkets now use just-in-time deliveries, relying on computer data systems. In manufacturing, systems are often based on Kanban cards—dockets for withdrawing and ordering items at each workstation of the production process.

9.7%

the average annual growth expected in the global print-on-demand T-shirt market in 2021–2028

CASE STUDY

Print-on-demand publishing at Peecho

Amsterdam-based Peecho offers just-in-time print-on-demand services, only printing the products they host, such as books and images, when ordered by a customer:

- Content owner uploads their product, such as a book or image, to Peecho.com.
- Customer places order, and Peecho prints only the number of copies needed to fulfill order.
- Content owner avoids up-front costs of producing and storing large print run and can easily distribute their printed products anywhere.

Total quality management

Success through customer satisfaction is the ethos of total quality management (TQM). Everything a company does is relevant, and the focus is on managing and improving processes rather than outcomes.

How it works

Companies use TQM to create a customer-focused organization that involves all employees in continuous improvement. It is a strategic and systematic approach that puts quality at the heart of the business's activities and culture. Customers determine the level of quality, measured by their satisfaction. The organization is viewed as a series of horizontal processes that take inputs from suppliers through to the delivered outputs. Measuring performance data is critical, as is good communication to maintain momentum. Although similar to the more widespread Six Sigma (*see pp.320–321*), TQM focuses on internal quality standards rather than reducing defects and producing quantifiable results.

WHAT TQM MEANS

- **Total** Involves everyone and all activities in the company
- **Quality** Conformity to meeting customer requirements
- **Management** Quality can and must be managed

Case study: The Walt Disney Company

Manufacturing companies, in which the focus is on meeting or exceeding customer expectations by making products within certain specifications, are often used as TQM examples. TQM can also be applied in service industries, of which Disney is a good example.

> "Quality control is applicable to any kind of enterprise. In fact, quality control must be applied in every enterprise."
>
> Dr. Kaoru Ishikawa, *engineering professor*

The Walt Disney Company
Disney's goal is to maximize long-term shareholder value, and part of this involves delivering a magical customer experience at its theme parks.

Focus on the customer
Disney incorporated the TQM concept of quality into its approach to customer service. Its visitors are seen as guests and treated as VIPs and individuals.

Involve everyone in quality
Founder Walt Disney firmly believed in quality and saw it as everyone's job, something that could not be delegated.

Perfect processes
Walt Disney viewed the theme parks as factories producing delight. He built quality by designing processes and repeating them.

70,000

Disney World "cast members" work to make guests happy.

Employees
Disney calls its employees "cast members." They are trained in every aspect of delivery, including posture, gestures, facial expressions, and tone of voice.

Exceptional service
Cast members (employees) are focused on delighting the customer—their sole job is to make visitors happy.

Suppliers
Disney collaborates with suppliers—for example, it has partnerships with McDonald's and Coca-Cola—to ensure consistent quality.

Continuous improvement
Walt Disney saw the theme parks as an incomplete product; today, improvements come from the bottom up.

"When does the Three O'Clock Parade start?"
Cast members are trained to answer this common question by responding with the time the parade will be passing a particular point in the park.

Shared purpose
Walt Disney started by defining a company culture based entirely on creating a genuine shared purpose that people would be proud to support.

Integrated systems
Technology supports the experience: for example, the volume of ambient music is the same in all theme parks, delivered through thousands of perfectly placed speakers.

✓ NEED TO KNOW
- **American customer satisfaction index (ACSI)** Cross-industry benchmarks for customer satisfaction in the US; NCSI is the UK equivalent
- **Net Promoter Score (NPS®)** Metric for company performance from the perspective of customers, who are divided into promoters, passives, and detractors

Time-based management

The general approach that recognizes the importance and value of time and seeks to reduce the level of unproductive time in an organization is called time-based management.

How it works

The fast pace of competition means a business that can manage time efficiently will enjoy a significant competitive advantage. This applies to new product development, faster response times to meet changing market and customer needs, and reduced waste. For a business to operate a time-based management system, its people have to be multi-skilled and able to move swiftly between different tasks; its machinery has to be flexible so that production runs can be changed at short notice; and there has to be a culture of mutual trust between workers and managers. Time-based management is a key aspect of lean production.

Case study: managing time at Amazon

With approximately 398,264,685 square feet of storage space in its warehouses and hundreds of millions of customers worldwide, Amazon is an undisputed leader in online retail. One of its key strengths is being able to deliver products quickly, with many customers paying a premium to get their items even faster through its Prime subscription service. To be able to do this at a reasonable cost, the company ensures that every process adds value and takes a minimum amount of time—from making sure there is enough stock and space to store it to picking the right product and delivering it. Much of this is achieved through the use of information technology.

Storage

Amazon uses every available inch of warehouse space to store inventory by utilizing the idea of "chaotic storage." Items are placed in the location that optimizes the use of space rather than in an ordered categorized section. The inventory management system keeps note of where that item is stored and can locate it instantly, saving time and space.

Analysis

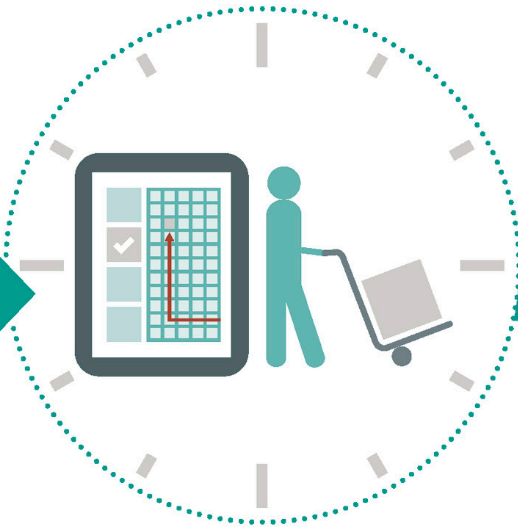
The time and cost of each of these processes is analyzed to ensure they are completed in the best possible way.

34% of organizations mostly or always complete projects on time.

PART OF PROJECT MANAGEMENT

Time-based management is a critical part of project management. Timing aids include:

- **Tools** such as Gantt charts show the project schedule as a bar chart, making it easy to plot and monitor daily progress and targets.
- **Project management systems** PRINCE2 (PRojects IN Controlled Environments) and similar methods help structure projects step by step in logical, organized ways.
- **Methodologies** such as Agile help project managers working in software development respond to the unpredictable; they are often implemented via the Scrum framework, in which one person takes charge of constant reprioritizing. Based on the premise that software cannot be built up like a product on an assembly line, as it would be out of date before it was released, every area of development is constantly reappraised.



Picking the order

Computer systems direct the pickers to the nearest location for that product, which not only saves time but also avoids costly and time-wasting picking errors where the wrong product is inadvertently selected.

Despatch

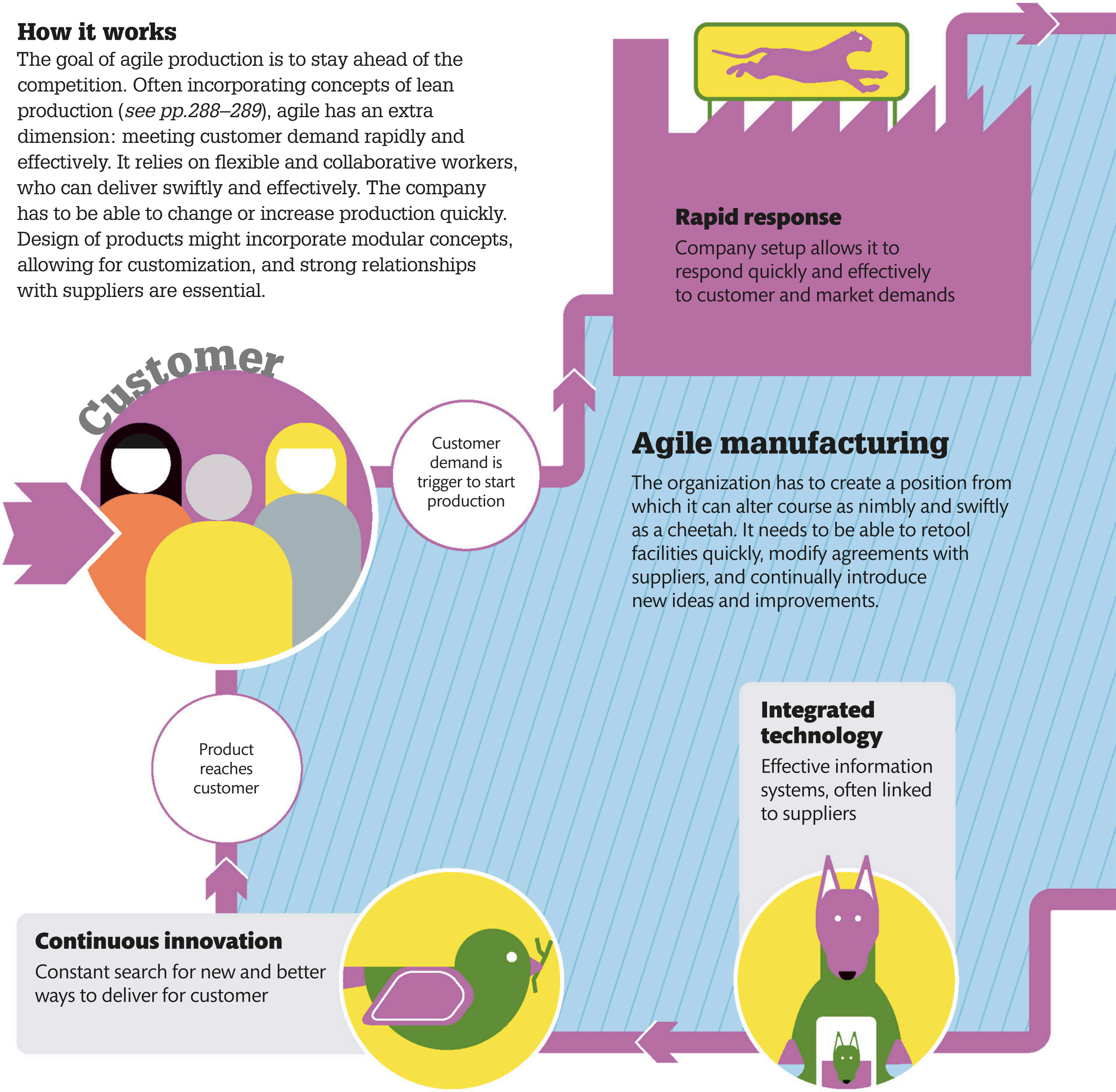
After picking, the product moves along a conveyor for packing, weighing, and labeling. This is then tracked and scanned by the computer system before being sent to the sorting center, where packages are distributed by location and delivery speed.

Agile production

Speed and agility are the key competitive advantages of agile production: the focus is on rapid response to the customer, enabling the business to take advantage of short windows of opportunity.

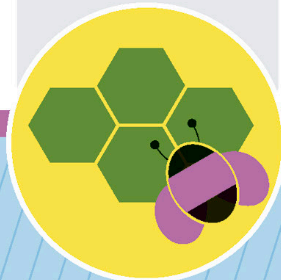
How it works

The goal of agile production is to stay ahead of the competition. Often incorporating concepts of lean production (*see pp.288–289*), agile has an extra dimension: meeting customer demand rapidly and effectively. It relies on flexible and collaborative workers, who can deliver swiftly and effectively. The company has to be able to change or increase production quickly. Design of products might incorporate modular concepts, allowing for customization, and strong relationships with suppliers are essential.



Knowledge culture
Capturing experience, learning from mistakes

Modular products
Independently created parts used in different/customized products



LOCAL EDGE

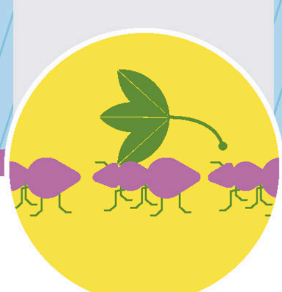
Agile production is typically adopted by companies in extremely competitive environments with high labor costs, such as North America, where local manufacturing can provide a competitive advantage:

- Proximity to customers allows feedback and response.
- Small variations in performance and delivery can make a huge difference in customer satisfaction, company reputation, and financial results.
- Unprecedented levels of speed and personalization cannot be matched by offshore competitors.

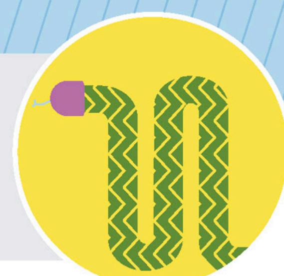
71%
of organizations use agile approaches for projects at least sometimes

Strategic partnerships
Supplier collaboration rather than contract negotiation

Transportation system
Systems, facilities, infrastructure to speed product to customer



Flexible workforce
Self-organizing, adaptable teams



Kaizen

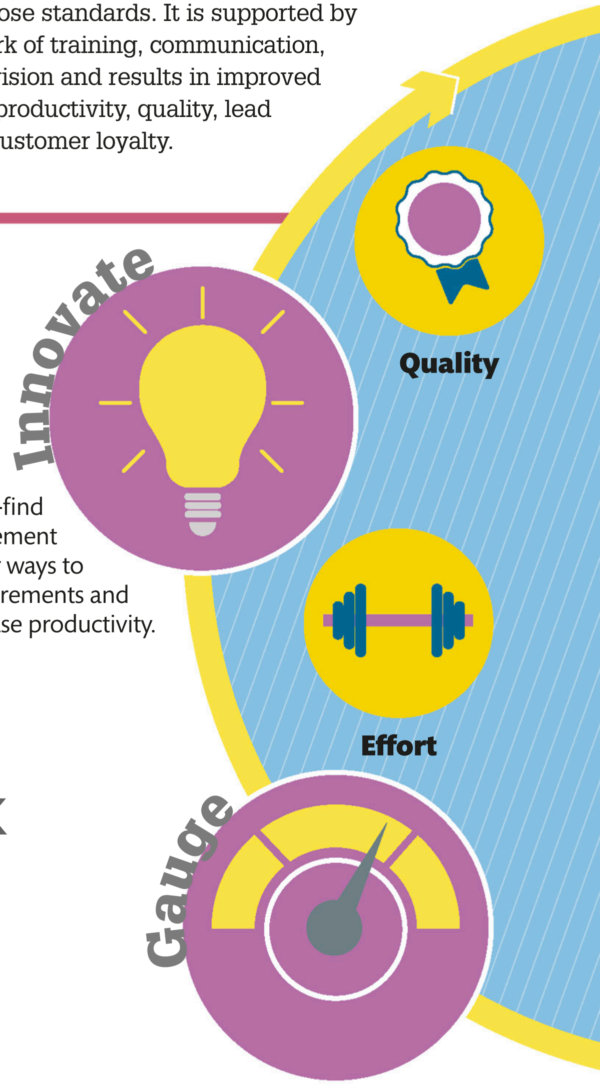
Started in Japan, kaizen is a system of continuous improvement that involves all employees. From senior managers to store employees, everyone is encouraged to suggest improvements day to day.

How it works

The kaizen philosophy is "to do it better, make it better, improve it even if it isn't broken, because if we don't, we can't compete with those who do." Kaizen is rarely about ideas for major change but has more to do with ongoing, systematic, incremental improvement. A relentless attempt to eliminate unnecessary activities, delay, or waste (*muda*), Kaizen starts with setting high standards and then looking for ways to continually improve those standards. It is supported by a framework of training, communication, and supervision and results in improved efficiency, productivity, quality, lead time, and customer loyalty.

Creating good change

Kaizen events are implemented through a cycle of activity, known as plan, do, check, act. Central to kaizen are quality, ongoing effort, involvement of every employee as part of their daily work, willingness to change, and communication.



Innovate—find and implement better ways to meet requirements and increase productivity.

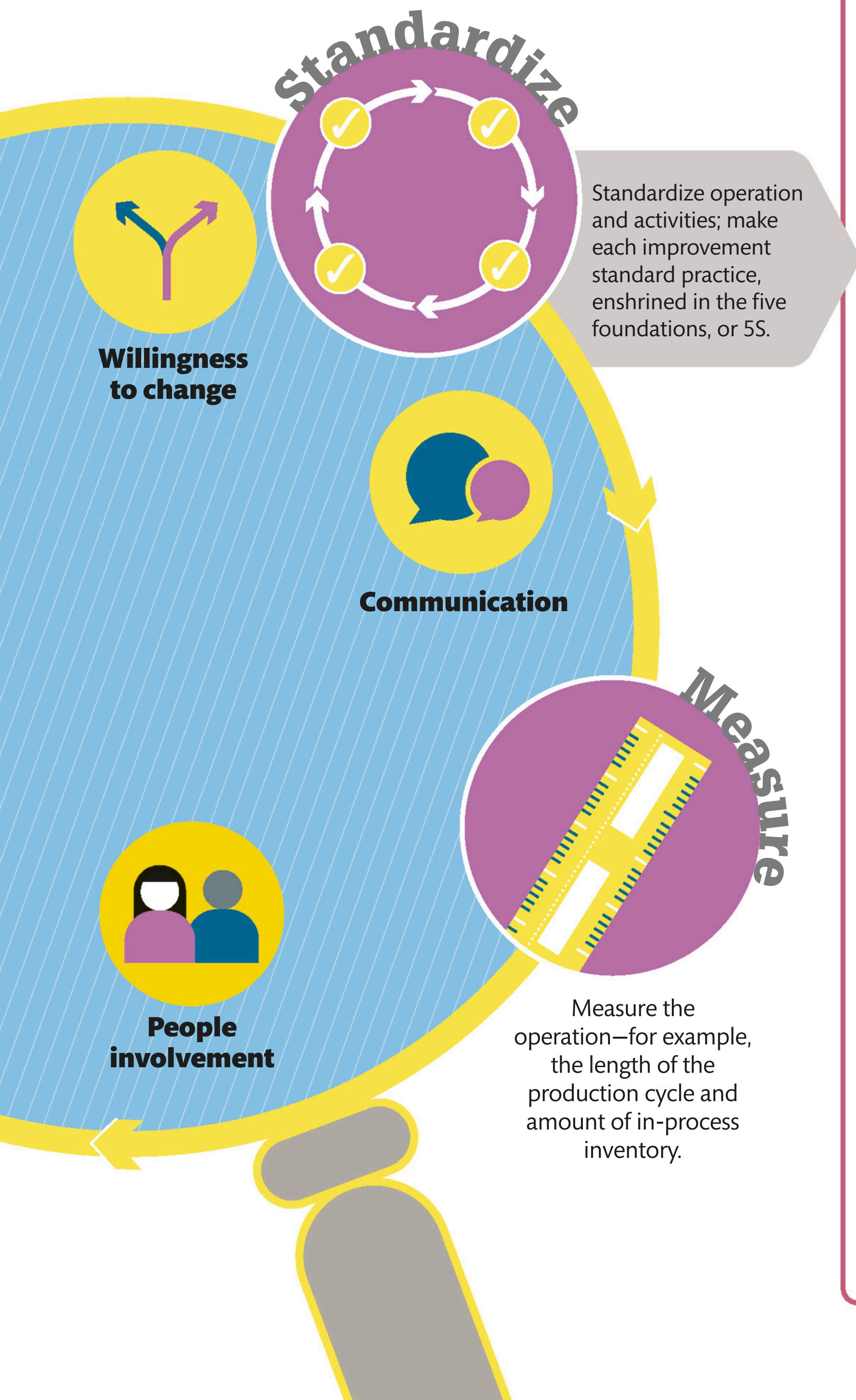
Gauge measurements against required standards.

BETTER AND BETTER

Kaizen was created in Japan after World War II. It comes from the Japanese words *kai*, which means "change" or "to correct," and *zen*, which means "good." Companies such as Toyota and Canon have seen significant improvements by involving their employees in recommendations for change.

KAI	ZEN
改	善
CHANGE	GOOD

29 seconds saved building each car at Toyota UK from new idea to automate adding stickers



FIVE FOUNDATIONS

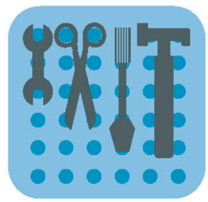
The five steps of workplace organization, known as 5S, are the foundations for continuous improvement in kaizen.

Seiri (Sort)

Keep only essential items in the work area. Remove and store all unnecessary items.

Seiton (Streamline)

Retrieve ordered items swiftly and easily to create efficient workflow.

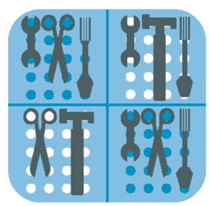


Seiso (Shine)

Keep the workspace clean, because cleanliness leads to efficiency.

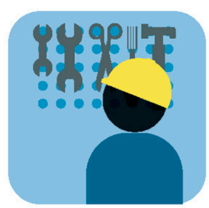
Seiketsu (Standardize)

Keep consistent work practices, tools, and workstations and make roles clear.



Shitsuke (Sustain)

The four cornerstones above become the standard way to operate all the time.

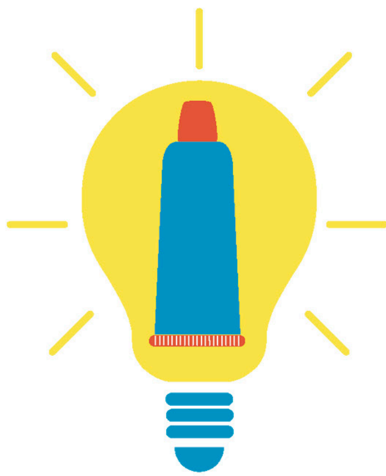


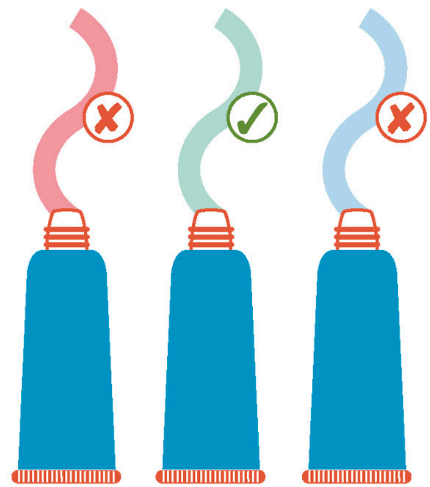
Product

The items that firms sell to satisfy a consumer need and to make a profit for the business are broadly termed products, whether they are something tangible like toothpaste or an intangible service, such as an insurance policy. In a typical life cycle, a product is developed and launched, and a few customers buy it. The domino effect causes wider distribution. Growth eases as the market becomes saturated, and sales flatten and decline until the product is no longer viable.

Product evolution

From start to finish, every product, such as a tube of toothpaste, goes through a process of testing, innovation, and quality control to ensure that it will make the biggest impact on release and throughout its life-span. Successful companies understand the limited life-span of products and thus invest in the early stages to maximize growth later on.





"A lot of times, people don't know what they want until you show it to them."

Steve Jobs, *Apple Inc. cofounder*

New product idea

A company decides to release a tube of toothpaste with a new flavor. Its viability is evaluated and potential competition researched. The new toothpaste also requires other qualities, such as whitening and enamel protection, to capture its segment of the market. *See pp.304–305.*

Testing and development

A focus group is assembled to taste the new flavor, along with some variations. Their preferences and comments are noted, and the toothpaste is developed into a usable product. *See pp.302–303.*

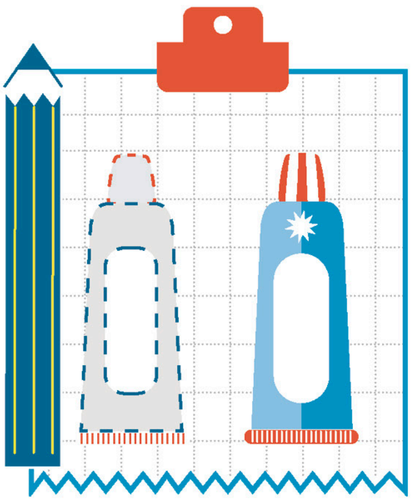
$2.8 trillion

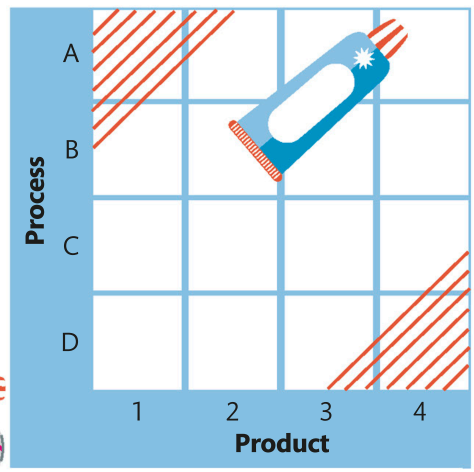
the value of goods traded between EU member states in 2020

PRODUCT LIFE-SPAN

Home entertainment offers different products to consumers. These are four examples of products at different stages in their life cycle (*see pp.184–185*):

- **Introduction** 8K ultra-high definition televisions only recently available for the home
- **Growth** Streaming services—more subscriptions due to convenience, value, and content choice
- **Maturity** Regular high-definition televisions—challenged by more sophisticated technology
- **Decline** DVD players—DVD discs superseded by cheaper, higher-resolution streaming services





Packaging and design

The toothpaste tube is given a bright, clean, and attractive look. Design considerations include functionality, expense of materials, and an appeal to current trends. *See pp.306–307*.

Quality management

A period of quality control begins, in which standards of safety and performance are thoroughly checked. It is far cheaper to correct defects in the design phase than later in production. *See pp.308–309*.

Product-process matrix

Using a product-process matrix, the company identifies the correct production method for the toothpaste. Because the company makes only a few products, each at a high volume, it decides to use assembly-line production. *See pp.310–311*.

New product development

Companies cannot stand still. In today's fiercely competitive marketplace, they have to budget for research into new ideas and identify new products to bring to market simply to stay in business.

How it works

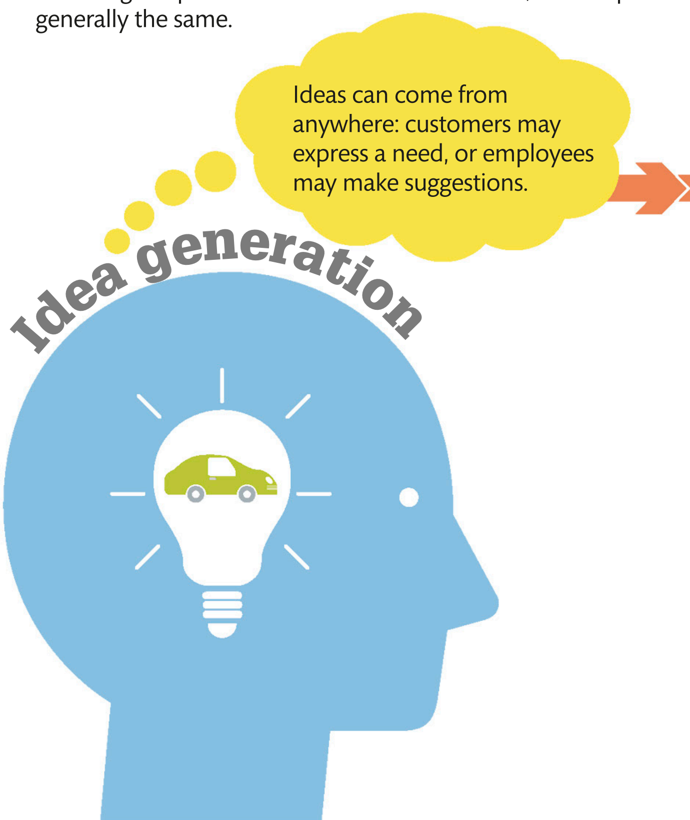
New product development is a process with a number of critical stages to ensure that a business focuses its investment on products that will sell and, above all, make a profit. It starts with an idea, possibly to improve and relaunch an existing product. Some companies run sessions to encourage creativity and generate a pool of ideas, a few of which can be explored. They might work with potential customers and also with suppliers, if part of the manufacturing process is to be outsourced, to refine and develop ideas before finally bringing the product to market.

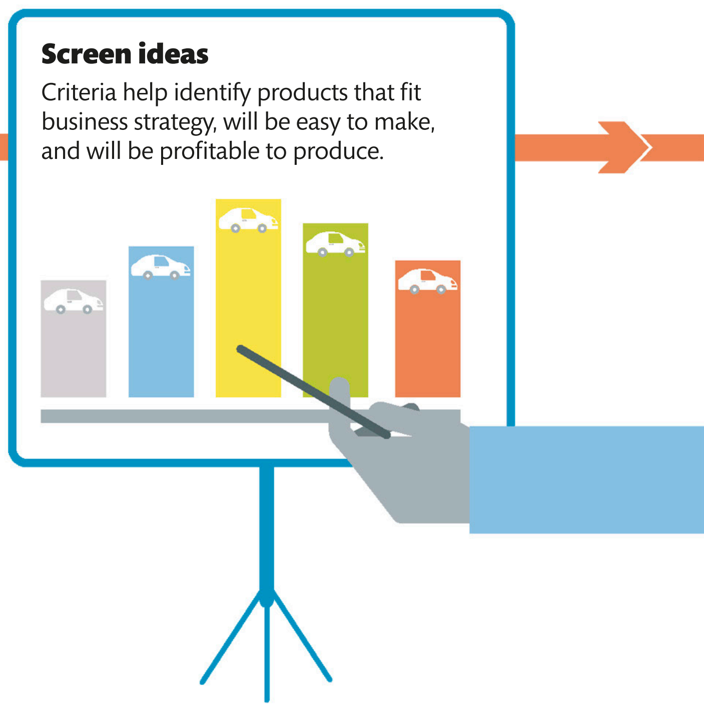
TRENDING CLAIMS

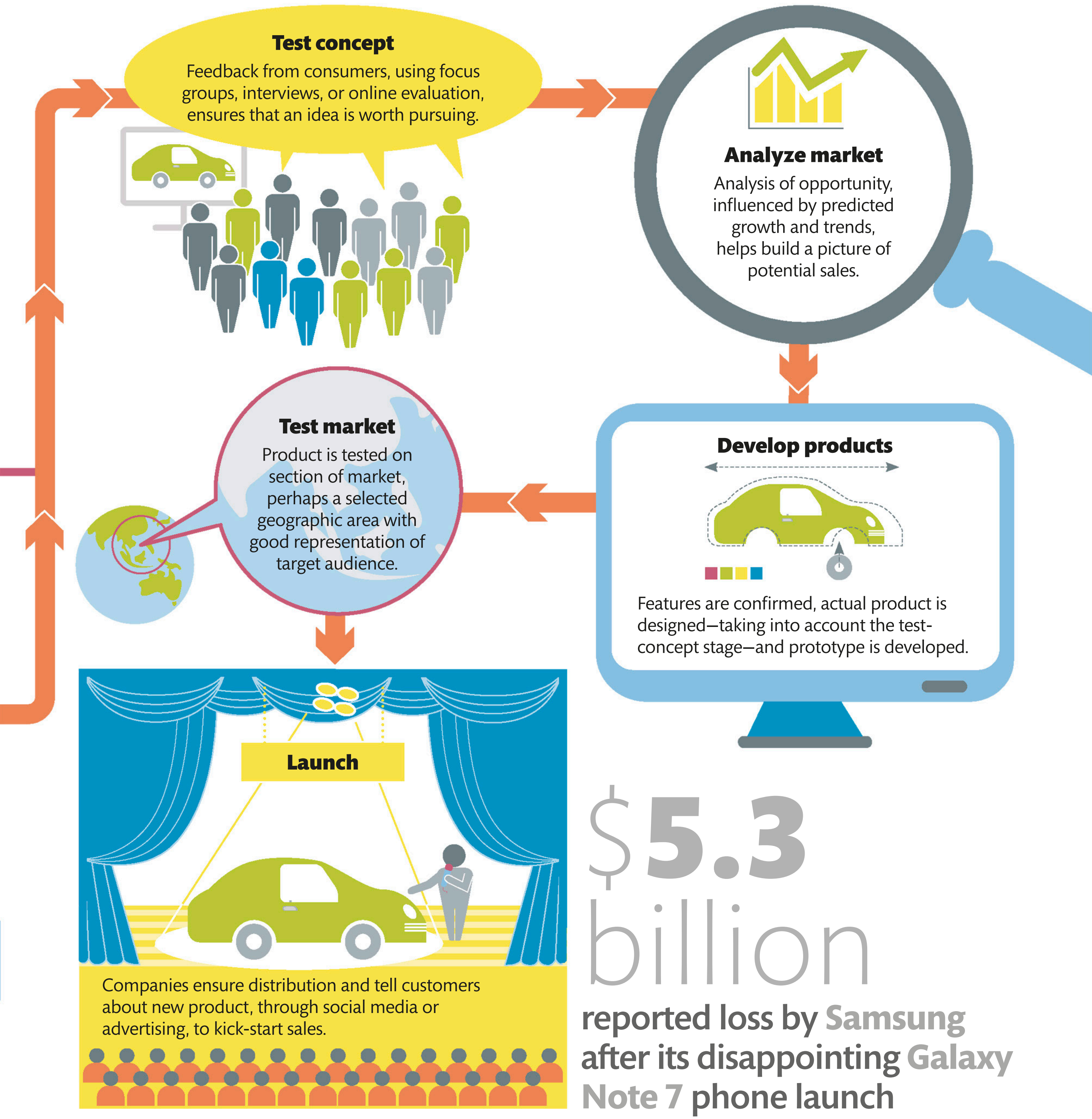
New products are influenced by trends, reflected in the claims on packaging and in advertising. The top claims on new food products in the U.S. from 2020, for example, were "kosher," "low allergen," "gluten-free," and "no additives."

The development process

The nature of the idea and the size of the company affect each stage and how long the product takes to reach the market, but the process is generally the same.







$5.3 billion

reported loss by Samsung after its disappointing Galaxy Note 7 phone launch

Innovation and invention

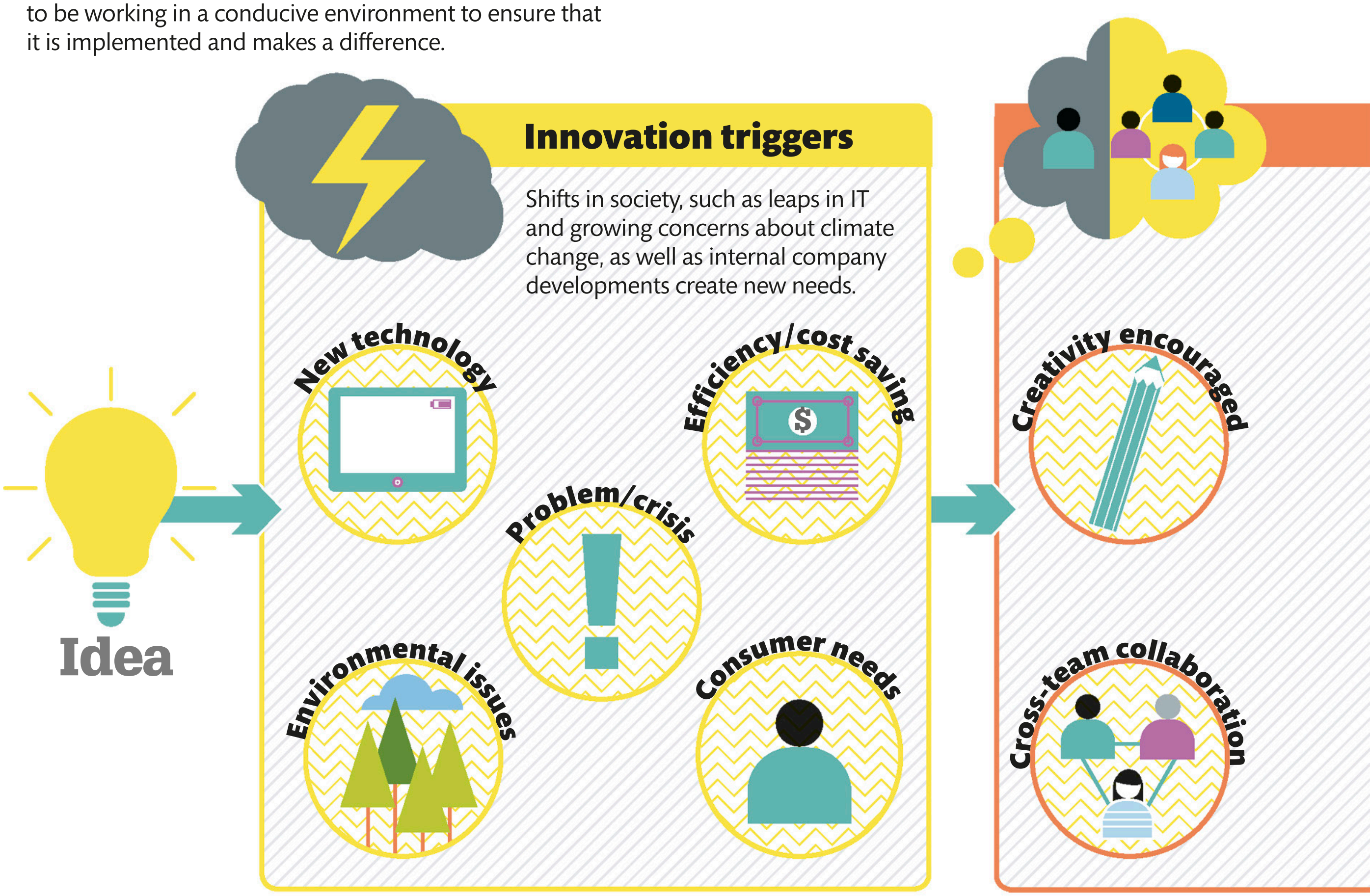
Innovating is more than just having a bright idea—it is the way that inventions and ideas reach commercial success. It is the lifeblood of any company, because staying ahead is essential for survival.

How it works

Innovation needs a culture that encourages people to be inventive and explore ideas. It also requires processes that can take initial ideas and develop them. Successful businesses, such as the Apple, Sony, and Huawei technology companies, know how to do this. Innovation is not small, incremental changes but transformational ones, such as solving an existing problem in a radically different way or identifying an unknown problem and inventing a solution.

From idea to product

Innovation is stimulated by many triggers. The idea then requires people to be working in a conducive environment to ensure that it is implemented and makes a difference.



DIFFERENT TYPES OF INNOVATION

Sustaining innovation Significantly improving existing products, typically through technology—for example, more pixels in cameras, smaller and more powerful laptops

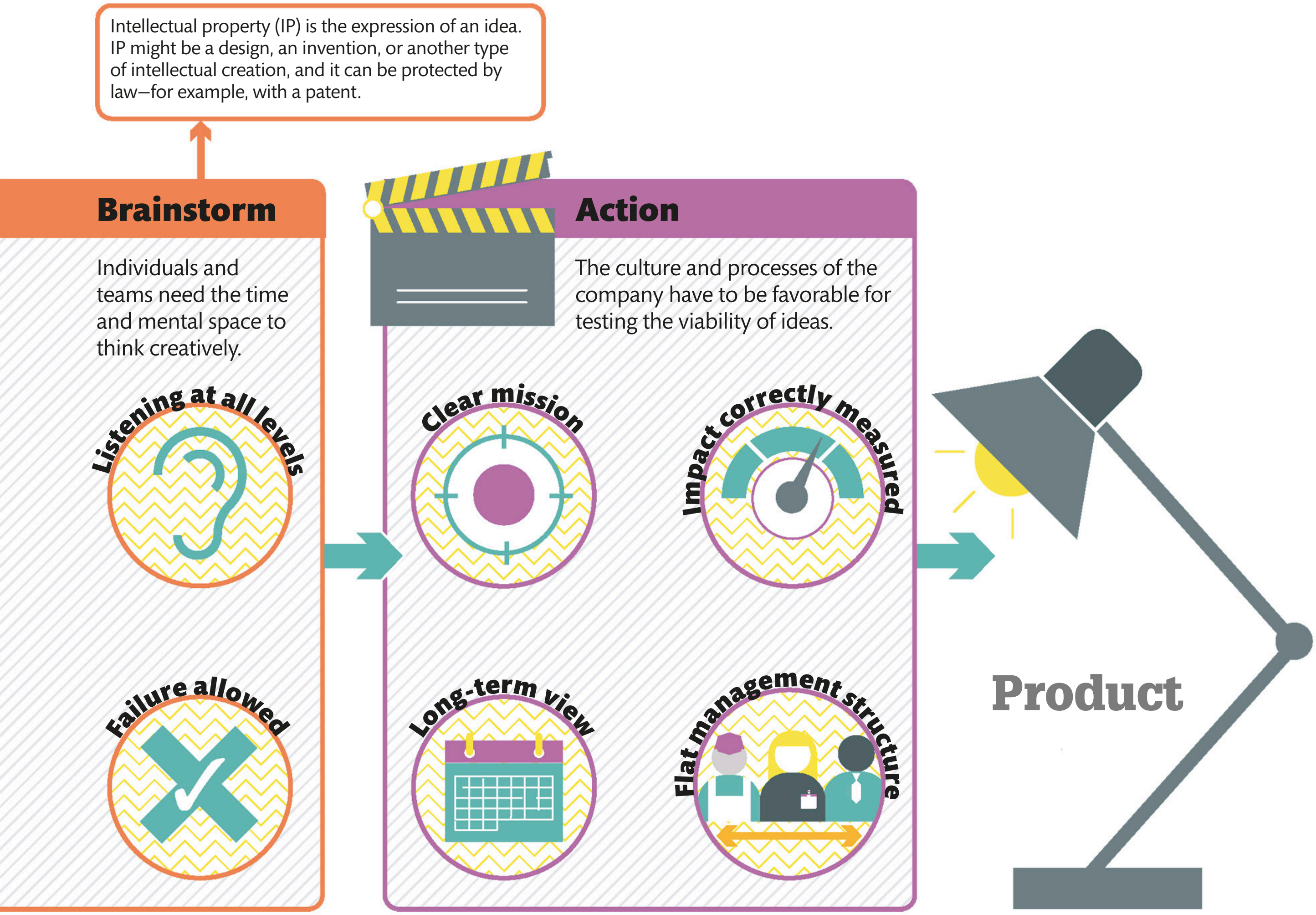
Sustainable or eco-innovation New product that has minimal impact on the environment

Frugal innovation Low-cost product for emerging mass market

Breakthrough innovation Product or service that simultaneously shifts a market and has significant outcomes for the world at large, such cloud computing or self-driving vehicles

Disruptive innovation Displaces established competitors or changes the norm—for instance, online gambling replacing betting parlors

> "Genius is 1 percent inspiration, and 99 percent perspiration."
>
> Thomas Edison, *U.S. inventor*

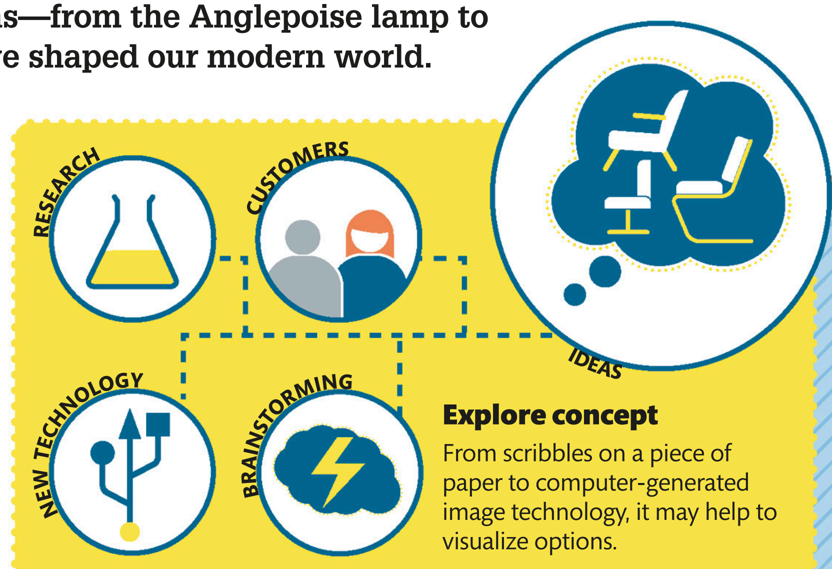


Design

Any product has to be well designed to succeed. Excellent designs for everyday items—from the Anglepoise lamp to reflective road signs—have shaped our modern world.

How it works

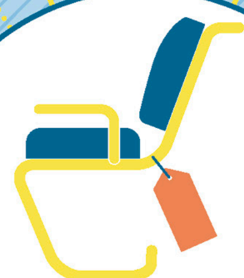
The starting point for design is an idea for a product that fulfills a need, whether it is a specialty item or something in day-to-day use. The designer has to think of ways in which a product can serve its purpose and meet other criteria, including aesthetics, cost, durability, and environmental considerations. The design may be integral to the product, such as Apple's rectangular devices with rounded corners, for which it obtained a design patent. Some designs are iconic, such as the Coca-Cola bottle. Yet design is more than just shape. As well as functionality, it includes materials and color and extends from the products to their packaging.



Explore concept
From scribbles on a piece of paper to computer-generated image technology, it may help to visualize options.

Product-design process

Designs for mass-produced items, such as furniture, lighting, domestic appliances, and communications technology, take a lot of hard work. The process of creating a functional design that looks good has several steps.

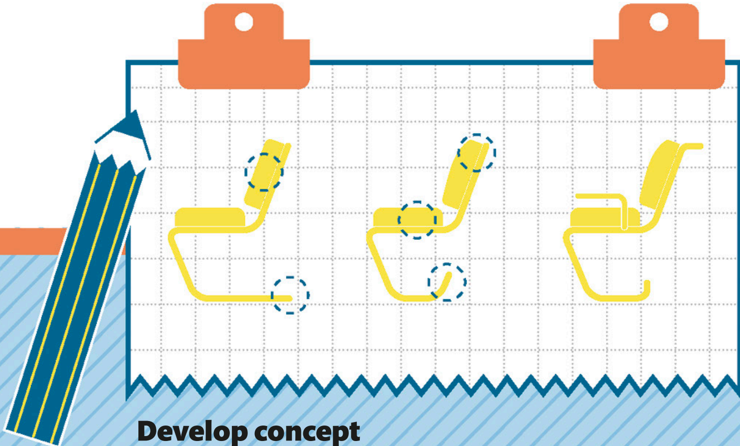


End product
The design of the final version that goes on sale may look very different from the initial concept.

Redesign
Next year, the product may need revamping.

CONSIDERATIONS FOR DESIGN SUCCESS

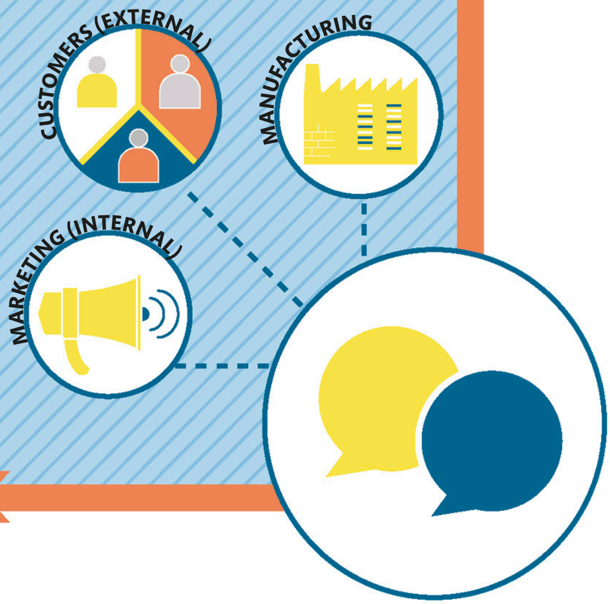
- **Functional** Serves a purpose
- **Aesthetic** Enjoyable to use
- **Innovative** Different and new, possibly using innovative technology
- **Easy to use** Understandable and with useful features
- **Simple** Unobtrusive, subtle
- **Long-lasting** Sustainable, not too fashion-sensitive
- **Environmentally friendly** Minimizes resources and pollution



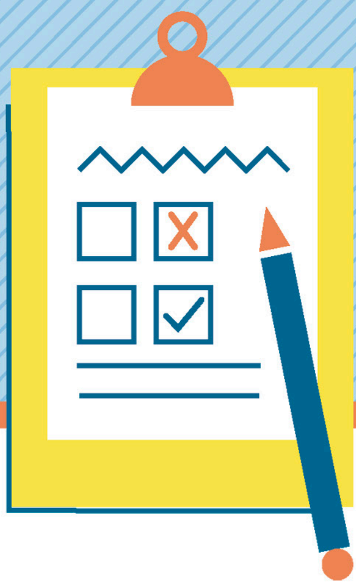
Develop concept
The design can be broken into components, such as functional requirements and production options, with each evaluated independently.

Make prototype
This might be a single item or a series of prototypes, to test and refine the functionality.

Feedback
Now is the time to find out what people think of the product and how it could be improved.



32%
higher revenue generated by the most design-focused companies over five years



Design decisions
Before full-scale production begins, all decisions have to be made, and paperwork, such as intellectual property rights, is finalized.

Quality management

For businesses, quality is not a vague term but a philosophy of meeting or going beyond consumer expectations. Excellent quality management can give a company a key competitive edge.

How it works

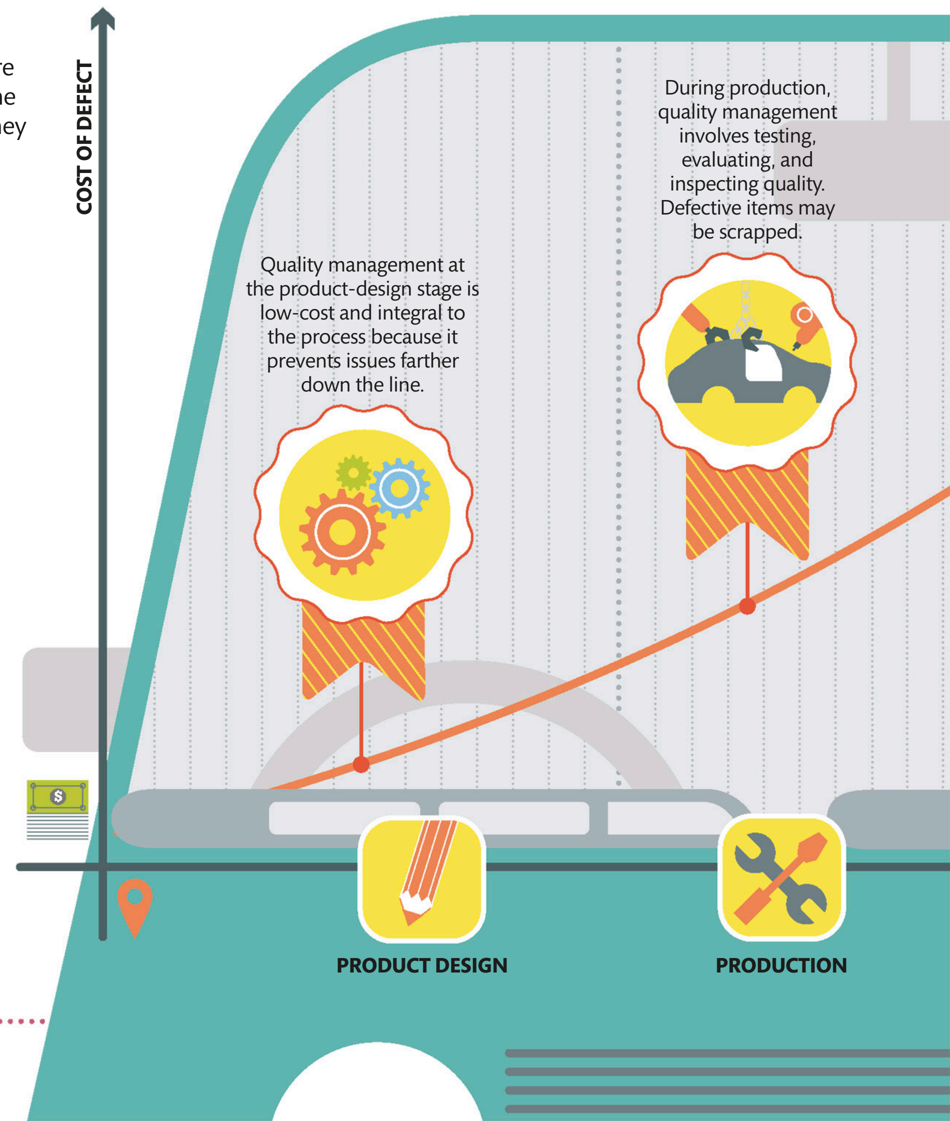
Many consumers might find it hard to define quality because it can be subjective, but they know it when they see it. However, companies need to define and measure it. They know that to build a good reputation and thrive, they have to exceed customers' expectations in terms of quality for both products and services. To do this, they have a number of standards or key performance indicators (KPIs) for the manufacturing process and continually measure themselves against these. Quality does not apply just to the product or service itself; it ripples out to the associated people and processes and across the organizational environment.

Cost of quality

Quality management is essential to ensure that any defects are nipped in the bud, the earlier the better, and definitely before they become apparent to the consumer.

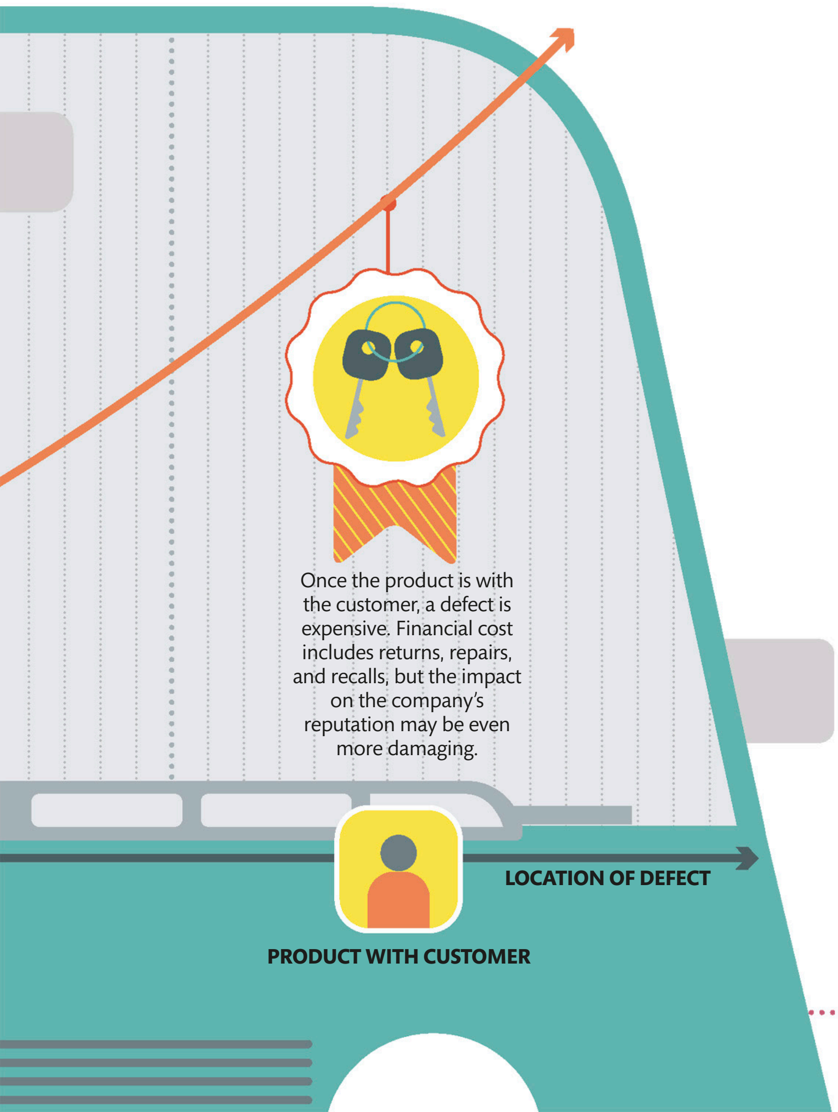
CUSTOMER FIRST

Before the 1970s, quality was seen as something to be inspected and corrected. Then, U.S. businesses began to lose out to Japanese companies—for example, Toyota and Honda were able to produce cars at lower cost and at much higher quality. The difference was that quality had a strategic meaning for Japanese firms—they made the customer their priority and were the first companies to define quality as meeting or exceeding customer expectations.



60%

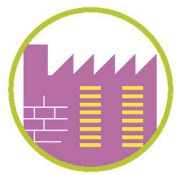
of organizations agree that customers are the key drivers of their quality programs.



NEED TO KNOW

- **ISO 9000** Set of international quality standards and certification demonstrating that companies have met standards specified
- **EFQM Global Award** Annual prize recognizing organizations worldwide for their ability to turn strategy into action and continuously improve performance
- **Deming Prize** Japanese award given to companies to recognize efforts in quality improvement

WHAT MAKES QUALITY?



Manufacturing industry

- Conformity to specifications/standards
- Performance
- Reliability
- Functionality/features
- Durability
- Serviceability

Service industry

- Getting the desired result
- Consistency
- Responsiveness to customer needs
- Courtesy/friendliness
- Promptness
- Psychological factors, such as good atmosphere

Product-process matrix

A product-process matrix is a tool that can help a business identify the best way to make a product, based on volume and the level of customization.

How it works

Products pass through different stages, and so does the production process. Businesses typically start with low volume and are highly flexible but not very cost-efficient. A print shop or dressmaker is an example of a company positioned in the bottom left-hand corner of the product-process matrix, where each job is unique and job production is most effective. Production stages then progress through increasing standardization and mechanization to full automation. Companies in the top right-hand corner have high-volume products and a small range, so continuous flow production is the best option.

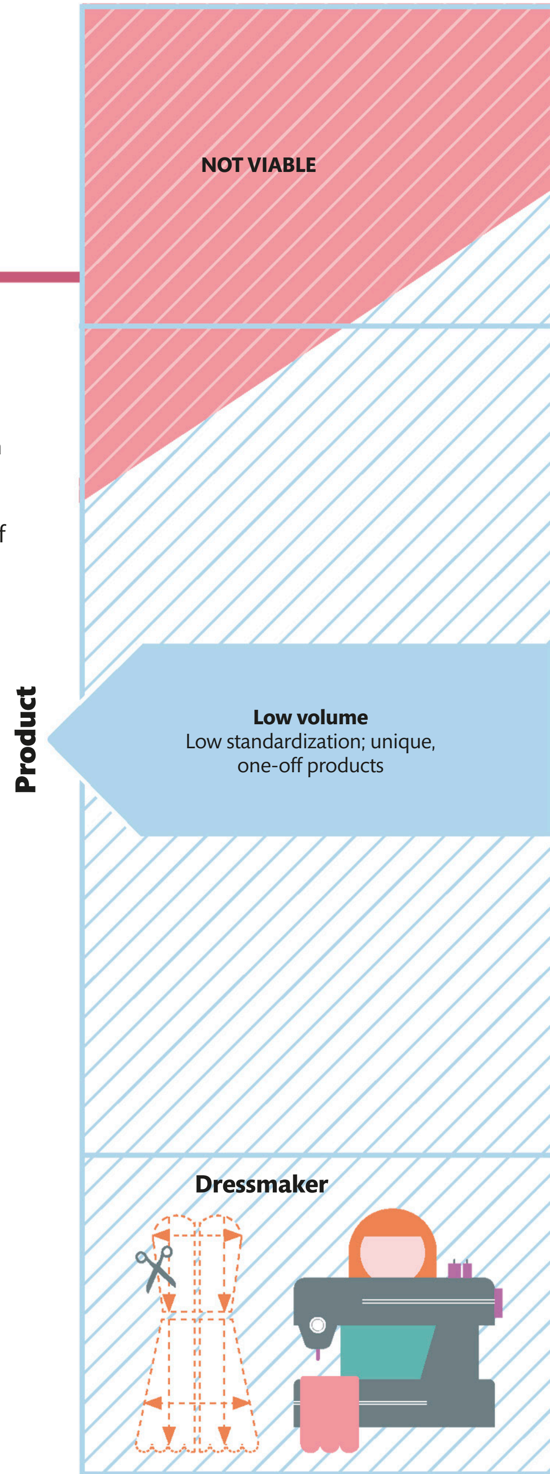
Choosing the best method

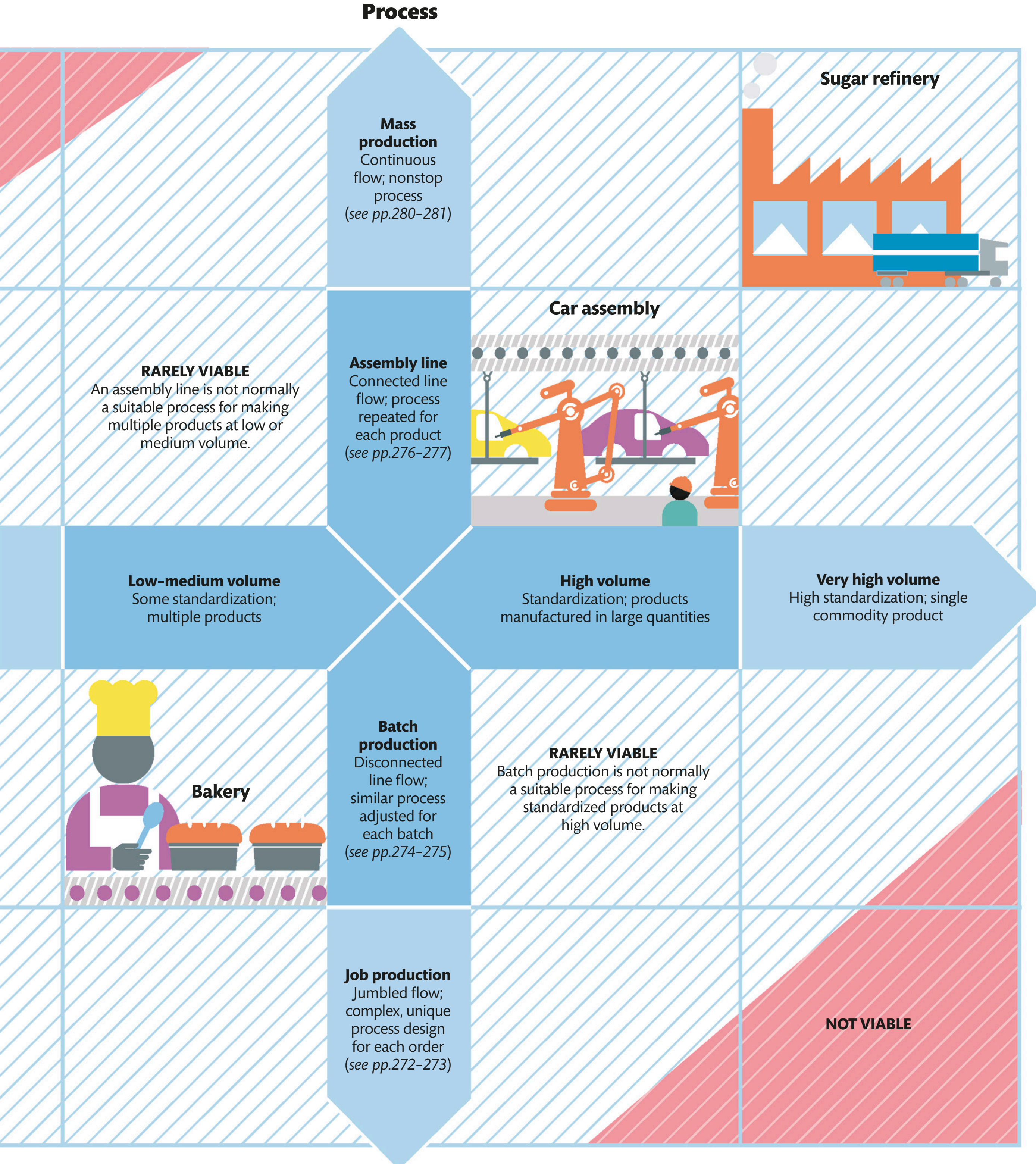
A business, or business unit in a large company, occupies a particular region in the matrix. Different processes suit different products, depending on the stage of their life cycle and the scale of the business.

29% of all goods are manufactured in China.

EVOLVING PROCESS

The product-process matrix was first introduced by Harvard academics Robert H. Hayes and Steven C. Wheelwright in the *Harvard Business Review* in 1979. Since then, some companies have worked out the apparent contradiction of how to customize high-volume products (mass customization). Nevertheless, the product-process matrix remains relevant in many industries.




Process
Mass production
Continuous flow; nonstop process
(see pp.280–281)
Sugar refinery
Car assembly
RARELY VIABLE
An assembly line is not normally a suitable process for making multiple products at low or medium volume.
Assembly line
Connected line flow; process repeated for each product
(see pp.276–277)
Low-medium volume
Some standardization; multiple products
High volume
Standardization; products manufactured in large quantities
Very high volume
High standardization; single commodity product
Bakery
Batch production
Disconnected line flow; similar process adjusted for each batch
(see pp.274–275)
RARELY VIABLE
Batch production is not normally a suitable process for making standardized products at high volume.
Job production
Jumbled flow; complex, unique process design for each order
(see pp.272–273)
NOT VIABLE

Control

Essential in any type of organization, control is fundamental when the primary goal is to generate profits. Control needs to cover costs, resources, and quality of the product or service to ensure that the operation runs smoothly. As well as crossing departments, control has to run from top to bottom, with directors formulating strategy while managers allocate resources, people, materials, and equipment and oversee the work of individuals and teams.

The chain of control

It is simplest to think of a business as an end-to-end chain. Leaders have to make decisions on business goals, strategy, and policies at the start of the chain. This is critical for control along the chain. If there is no clear direction from the start, problems become exacerbated as they travel farther along the line. Controls are put in place all the way along the chain to ensure that the organization is working toward its goals, that it meets the desired standards, and that individuals and teams are clear about what is involved in specific tasks.

Control in practice: strategic control

ABC Cake Company's goal is to be the top-selling cupcake business. Its directors determine the quantity and quality of cupcakes the company needs to sell and whether to invest in a new factory. They also set the scale of investment and estimate when it will begin to yield returns and how long it will take for the project to repay its full cost (payback period).

Management control

The management team ensures that everyone meets their targets, talks with other links in the chain, and works seamlessly to be a top-selling cupcake business.

FUNCTIONS ALONG THE CHAIN

While directors work on strategic investment, policy, and process control, management may use tools, such as Six Sigma, to perfect operational control. *See pp.320–321*.

Investment relies on cash flowing back into the business from the cupcake sales, balanced by the cost of production.

Policies on, say, maintaining the optimum level of inventory are supported along the chain by finance, HR, and IT.

Processes are in place to control costs, with continual reviews of the most efficient use of resources.

Procurement purchases raw materials from companies that meet its stringent standards.

84:1

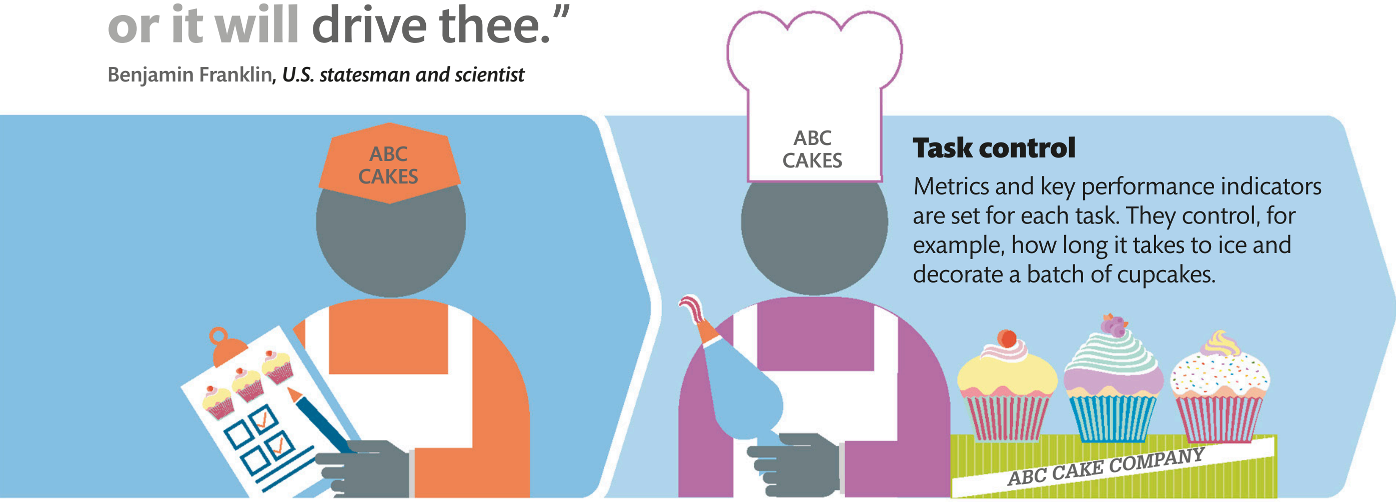
the median ratio of CEO to employee pay of FTSE 100 companies in 2019

LEGALLY IMPOSED CONTROL

Many industries are subject to external controls as well as their own:

- **Financial institutions** National and international regulatory controls
- **Advertising industry** National regulations to protect public interest
- **Health and social care** National laws to protect vulnerable members of the public
- **Manufacturing** National regulations on health and safety

> "Drive thy business, or it will drive thee."
>
> Benjamin Franklin, ***U.S. statesman and scientist***



Task control

Metrics and key performance indicators are set for each task. They control, for example, how long it takes to ice and decorate a batch of cupcakes.

Goods received checks on-time delivery and that all inputs are consistently of the right quality. *See pp.318–319.*

Stock control uses sophisticated systems to ensure the optimum level of inventory. *See pp.316–317.*

Production has metrics for the quantity and quality of the cupcakes. *See pp.314–315.*

Marketing benchmarks the price and reviews the promotion of the product against competition. *See pp.332–333.*

Sales works toward detailed targets. *See pp.314–315.*

Managing capacity

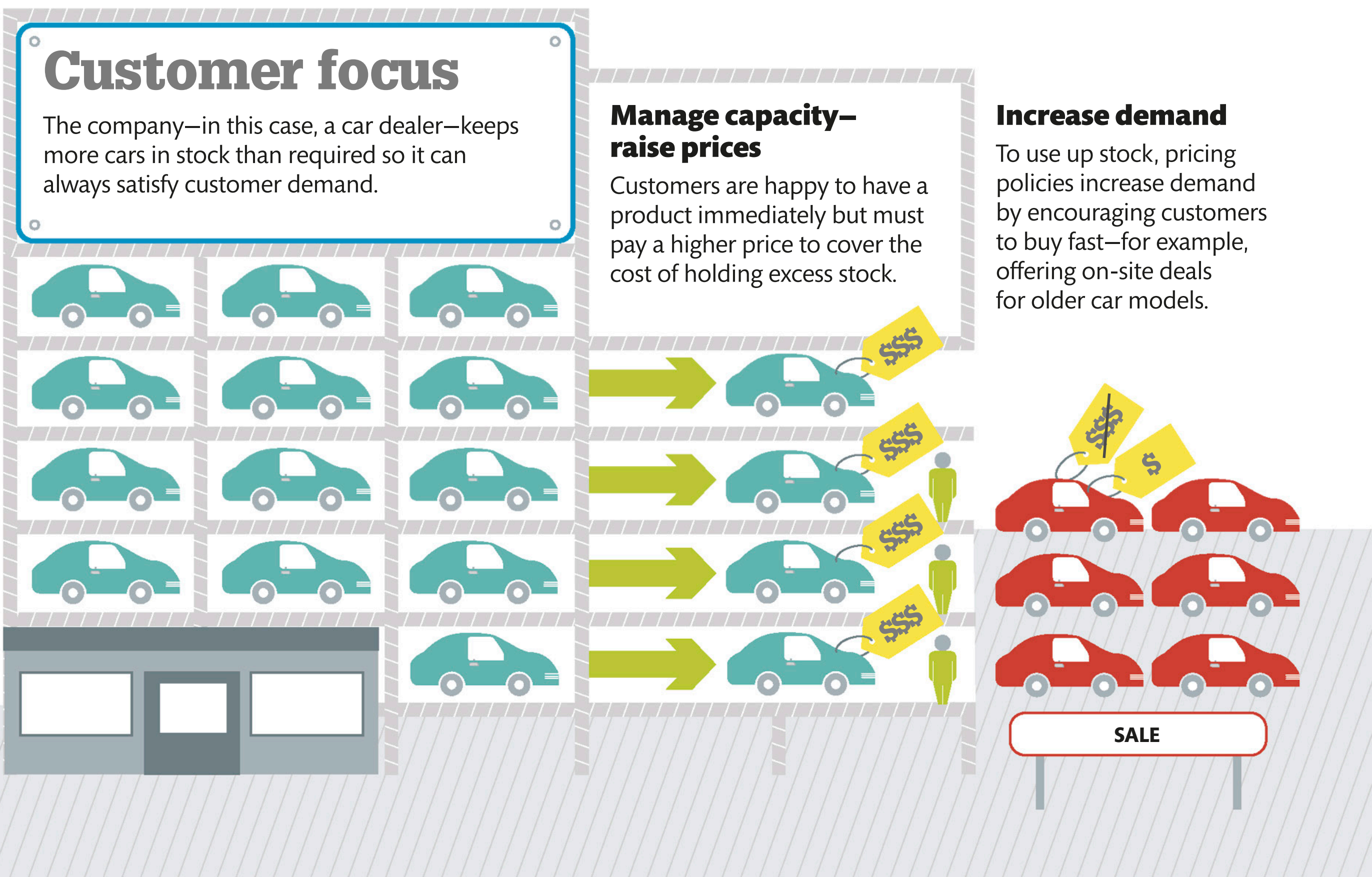
In terms of production, capacity means how much work can be achieved in a given time. Ideally, a business matches its capacity to customer demand, using its resources with maximum efficiency.

How it works

Every business has to consider how much capacity it needs for its operation and how to manage this capacity both day-to-day and in the future. Management has to choose a priority: whether to deliver excellent customer service by having extra capacity, and thus price its products or services high, or to manage its resources efficiently for a better return on investment, at the risk of disappointing customers if and when demand goes beyond capacity. Businesses may offer consumers incentives to help manage capacity—for instance, cheaper late-morning train fares encourage passengers to travel after rush hour, easing overcrowding on trains that are full to capacity in the early morning. Likewise, many hotel chains do not charge a fixed price for rooms, pricing them according to demand to maintain capacity.

Capacity decisions

The fundamental decision is whether to compromise on demand or capacity—whether to put customers or the streamlining of operational costs first.



HOW CAPACITY AFFECTS A COMPANY

Capacity management is critical to ensure, for example, that a manufacturing operation has the right level of resources to work to a production schedule. It affects many areas of the business, as all are interlinked and cost the company money:

- Factory or office size
- What and how much equipment is needed
- Staffing levels
- Use of labor—for example, shift work
- Which materials to use, how much/how often to order
- Inventory (stock) levels
- Production scheduling
- Speed and ease of processes
- Type of information technology used

NEED TO KNOW

- **Potential capacity** The capacity that can be made available long-term, a factor that affects investment decisions and business growth
- **Immediate capacity** The maximum potential capacity available in the short term
- **Effective capacity** The total capacity that is realistically achievable when all resources are being used optimally

Resource focus

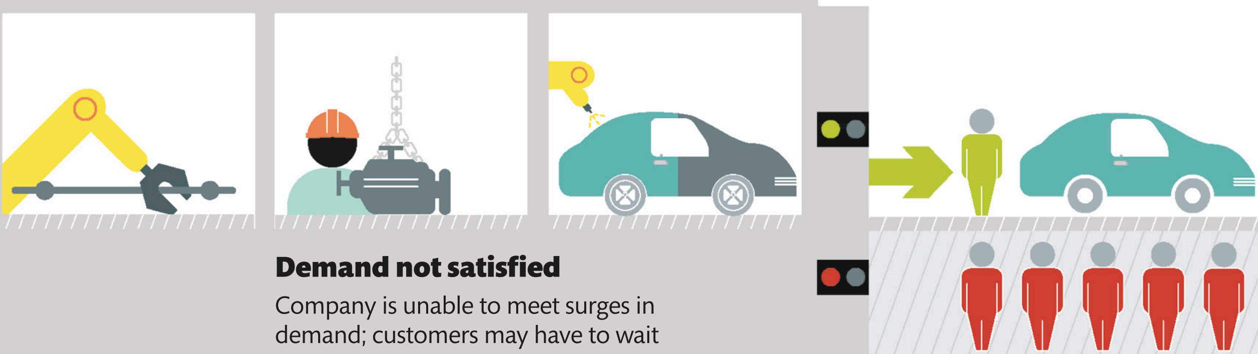
The company uses resources as efficiently as possible. Wastage is kept to a minimum, but satisfying demand is hard because work is at full capacity and output cannot rise.

50%

expected average annual growth in vehicle deliveries at Tesla to meet demand

Manage capacity—keep stock low

It produces stock according to demand and holds low inventory to minimize unnecessary spending and storage costs.



Demand not satisfied

Company is unable to meet surges in demand; customers may have to wait while production catches up, and business may be lost to competitors.

Inventory

Companies have to manage inventory (stock) to meet customer demand, even if they trade online and have no physical storefront. Successful inventory management is a complex process.

How it works

Stock may include finished goods, work in progress, and raw materials. Getting the right level is a balance between having enough to meet customer demand and having too much, which is costly in terms of finished goods, storage space, and warehouse staff. Stock may also lose value if it spoils or become unsalable because of changes in fashion or obsolete technology.

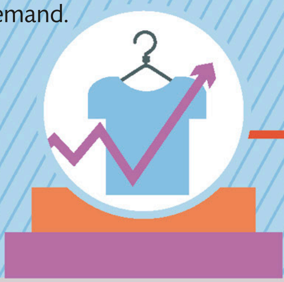
Effective inventory management involves systems and programs for sales forecasts, production targets, and actual inventory status, plus the physical tracking and handling of the different items. Bar codes and radio-frequency identification (RFID) tags have revolutionized inventory management, making it much easier to monitor stock levels.

Inventory management

Successful inventory management strikes a fine balance between satisfying customers and minimizing the risk of holding too much stock. In this example, the clothing company is managing the supply of T-shirts for a range of sites and for direct delivery to customers.

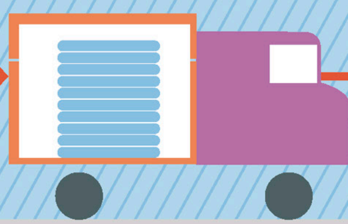
Make sales forecasts

The company sets production targets based on predicted demand.



Order from suppliers

Decisions on the level of raw materials to hold are based on lead times and reliability of suppliers.

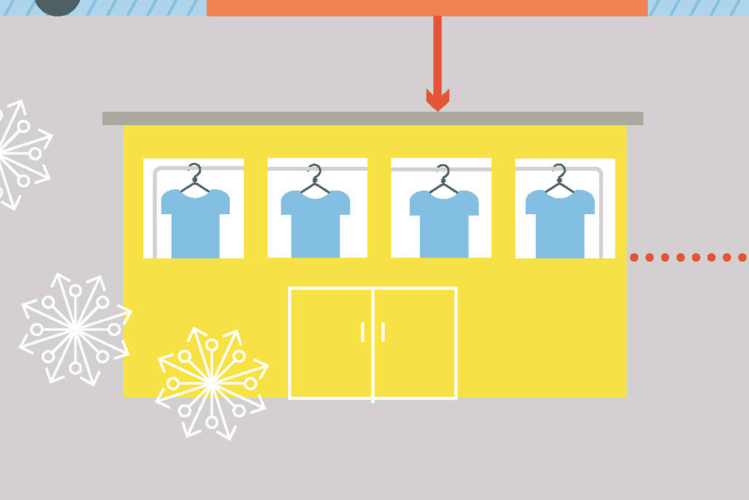


Production

The quality of raw materials and finished goods is checked at every stage of production.

Smaller storage

The company may use smaller facilities to hold extra stock—for example, to meet seasonal demand.



NEED TO KNOW

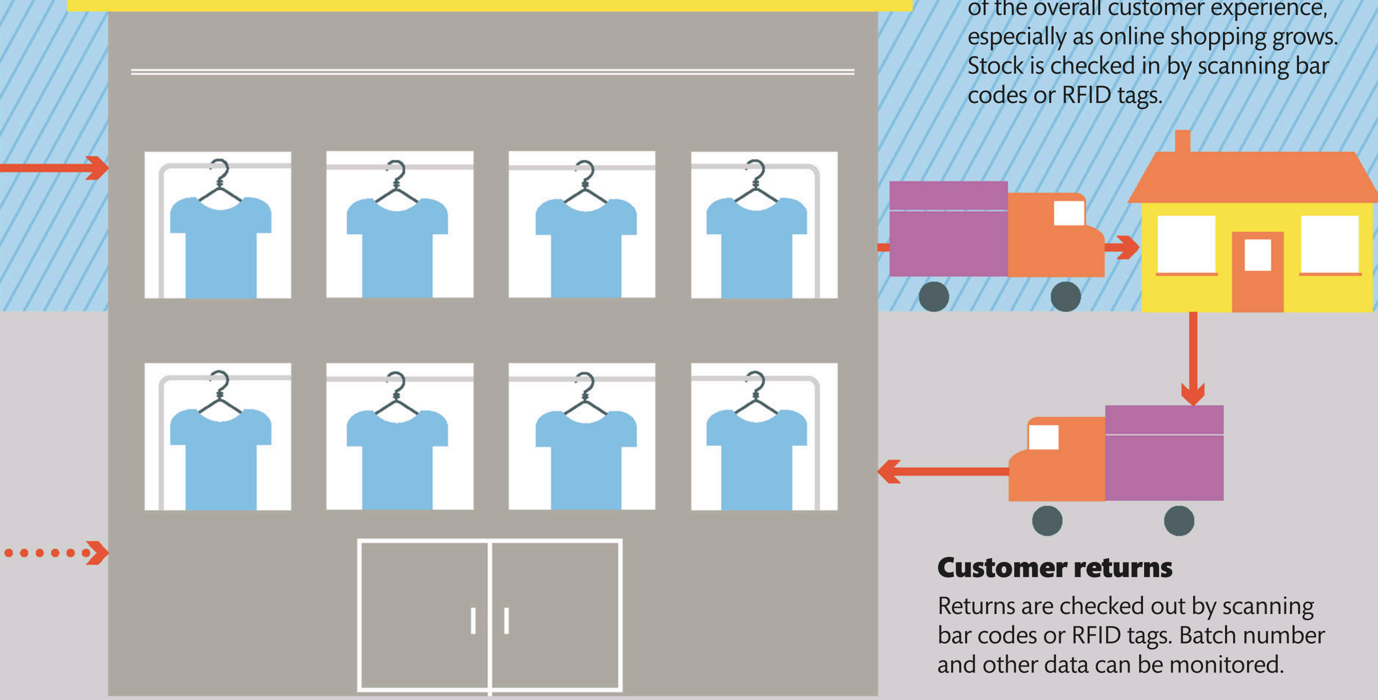
- **First in, first out (FIFO)** Oldest inventory items sold first (or recorded as sold for accounting purposes rather than physically moving goods)
- **Last in, first out (LIFO)** Most recently produced items sold first (or recorded as sold)
- **Stock-keeping unit (SKU)** A distinct item that has its own stock code
- **RFID tag** A chip that enables remote tracking of an item by radio sensors

$1.8 trillion

lost globally in 2020 as a result of retailers' inventory mismanagement

Main warehouse

The company may have one main warehouse or a number of warehouses as hubs for smaller storage facilities.



Delivery to customers

Efficient and timely delivery is part of the overall customer experience, especially as online shopping grows. Stock is checked in by scanning bar codes or RFID tags.

Customer returns

Returns are checked out by scanning bar codes or RFID tags. Batch number and other data can be monitored.

Quality control

There is a series of processes to ensure that a business maintains a required level of quality in its products or services. Quality control is particularly important in industries where safety is an issue.

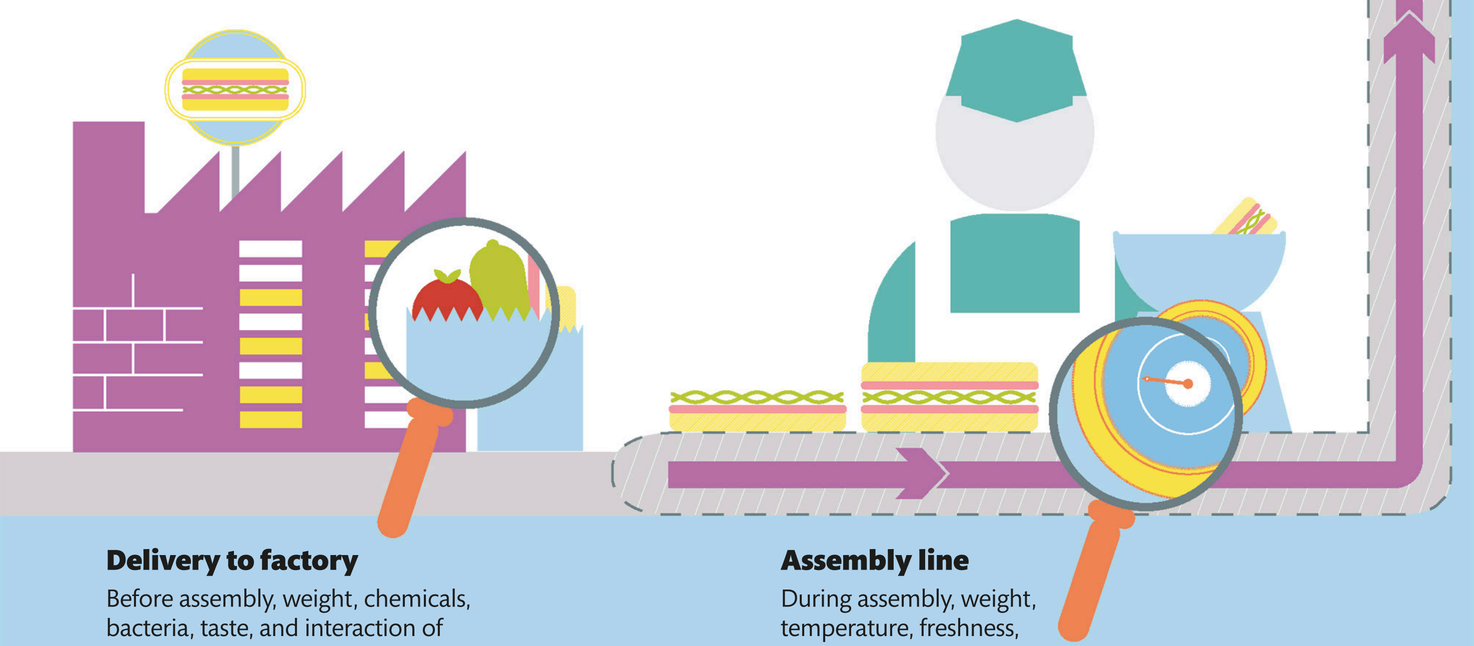
How it works

Businesses measure and manage the quality of their output against national legal standards and/or internal standards. For example, the manufacturing industry sets its own standards. Checking takes place against these and any national standards at various points along the production process, such as when raw materials arrive in the factory, during production, and before shipment of finished goods to the customer.

Quality control relies on a predetermined percentage of products for inspection, agreed corrective action, and remedial efforts to minimize future defects. Industries in which safety is paramount, including food, clothing, pharmaceuticals, construction, and car, train, and aircraft manufacture, are subject to extremely strict standards of quality control. Some are there to protect workers—for instance, if they are handling chemicals—while others safeguard the consumer.

The bread and butter of quality control

Hygiene and safety are essential in the food industry, as in this example of quality control in a factory making prepackaged sandwiches. Samples are tested all along the line. Any lapses in quality not only are a dangerous health hazard but would also be extremely damaging to the company's reputation.

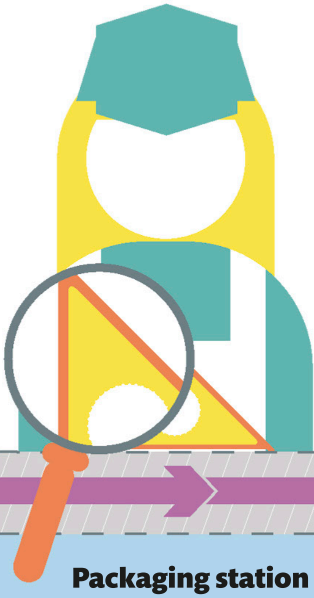


Delivery to factory

Before assembly, weight, chemicals, bacteria, taste, and interaction of individual ingredients are tested.

Assembly line

During assembly, weight, temperature, freshness, and visual appearance are assessed.



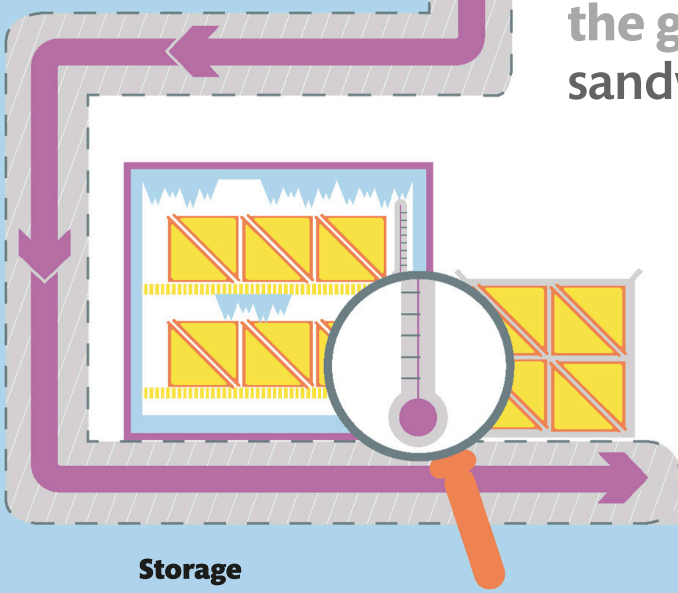
GLOBAL FOOD STANDARDS

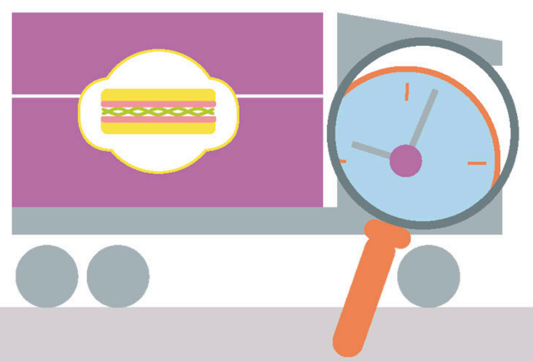
Ensuring the quality of food products as they cross the globe is vital for health and economies worldwide. Founded by the United Nations in 1963, the Codex Alimentarius is an internationally recognized set of food standards, guidelines, and codes of practice that helps do just that. Its voluntary, science-based provisions cover all aspects of food safety and quality, including hygiene, contaminants, and labeling.

$18 billion

the projected size of the global prepackaged sandwich market by 2025

Packaging station
Samples are tested to check that sealing is accurate, labels are correctly applied, and overall presentation is good.





Storage
The temperature is checked for accuracy and safety, and samples are tested for taste, texture, and contamination by foreign objects.

Transportation
The temperature in the vehicles and their delivery time are checked to ensure product freshness.

Six Sigma

Used in organizations to strive for near-perfect products and services, Six Sigma is a disciplined, data-driven approach for eliminating defects in any process.

How it works

The idea is that measuring the number of defects in any process makes it possible to systematically figure out how to eliminate them and get as close to zero defects as possible. Individuals are trained to become experts in the different methods, creating a cadre of black belts, green belts, and champions.

Every Six Sigma project is carefully documented, follows a defined sequence of steps, and has quantified value targets, such as increasing customer satisfaction or reducing costs. To achieve Six Sigma quality, a manufacturing process must have 99.99966 percent of output free of defects (3.4 defective parts per million).

SIX SIGMA ROLES

Six Sigma professionals are experts at improving processes. They drive the implementation of change.

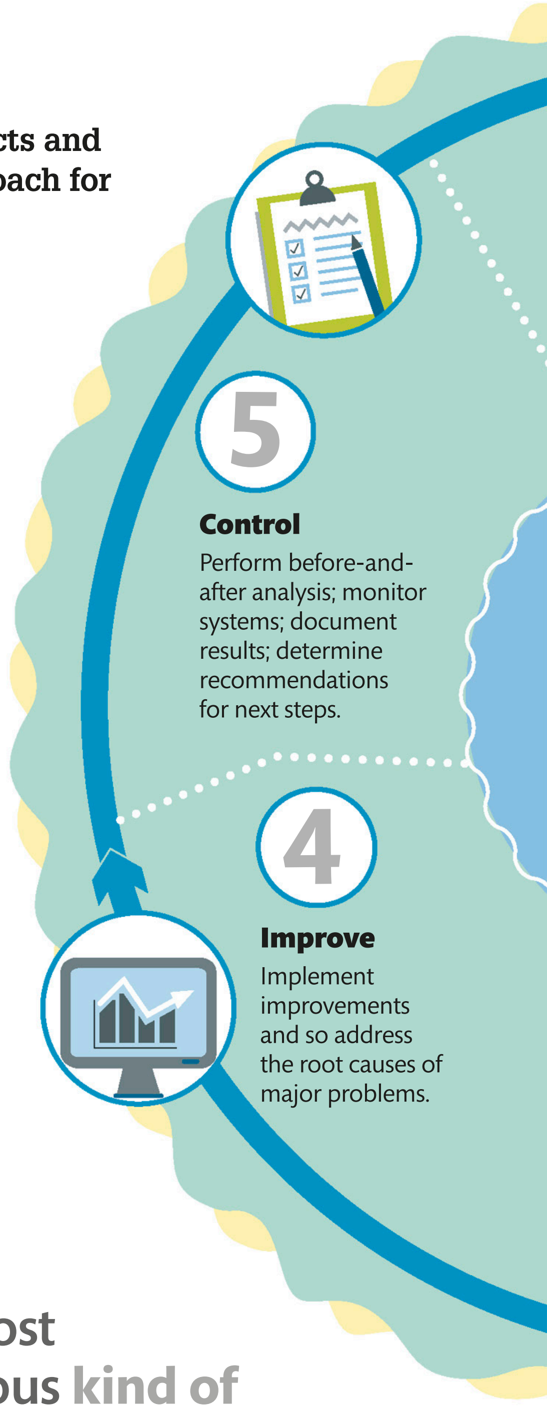
Master black belt Trains and coaches black belts and green belts; works at highest level, developing key measures and the strategic direction

Black belt Leads problem-solving projects; coaches project teams, assigning roles and responsibilities; trains green belts

Green belt Leads green-belt projects; helps with data collection and analysis for black-belt projects

Champions Translate the company's vision, mission, and goals to create an organizational deployment (OD) plan and identify individual projects

Executives Provide overall alignment by establishing strategic focus of the Six Sigma program within the context of the organization's culture and its vision of what the customer sees and feels



> "The most dangerous kind of waste is the waste we don't recognize."
>
> Shigeo Shingo, *industrial engineer and Six Sigma expert*

Striving for perfection

The DMAIC methodology (standing for Define, Measure, Analyze, Improve, Control) is an integral part of Six Sigma. It is used for improving existing business processes that are falling below targets and where step-by-step improvements can be made.

1

Define

Define the project's purpose and scope; identify processes that need improvement; determine customer needs and benefits.

2

Measure

Use data on current processes as a baseline; pinpoint problem locations and occurrences; identify potential areas for improvement.

3

Analyze

Identify root causes of problems and check them against data; determine precise improvements that need to be made.

CHAMPIONS

Cell phone maker Motorola pioneered Six Sigma quality in the mid-1980s, using it as a goal for its manufacturing operations; under CEO Jack Welch, General Electric was another early adopter. Since then, firms as diverse as the Credit Suisse bank, shipping company Maersk, and electronics manufacturer Samsung have adopted it.

✓ NEED TO KNOW

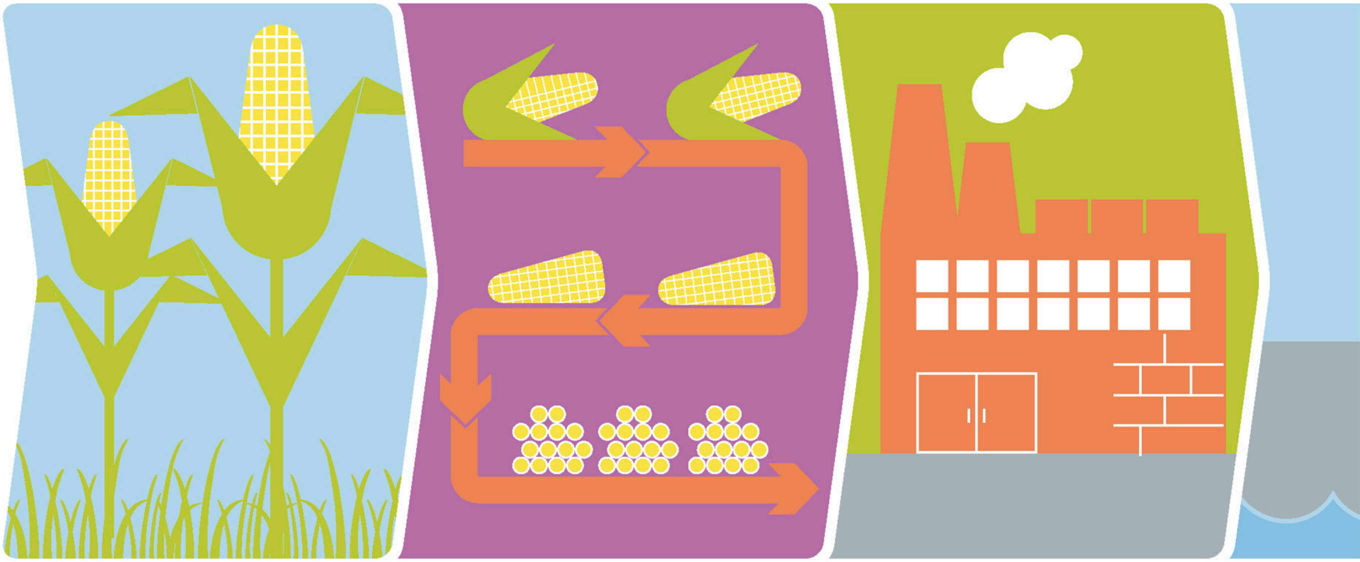
- **Lean Six Sigma** A combination of Lean production (*see pp.288–289*) and Six Sigma. The Lean part focuses on removal of waste from all activities, whereas Six Sigma focuses on reducing the number of defects.
- **DMAIC** Define, measure, analyze, improve, control—the cycle for improving existing processes to Six Sigma level.
- **DMADV** Define, measure, analyze, design, verify—the cycle for designing new processes or products at Six Sigma level. Also known as Design for Six Sigma (DFSS).

Supply chain

Along the journey from raw material to finished item in the hands of a consumer, every business needs an efficient supply chain. Supply chain management involves different organizations, people, activities, and resources to take, for example, grains of corn from a field to a finished box of cornflakes on the consumer's breakfast table. The company may outsource parts of the chain to other firms.

Supply chain management

The traditional supply chain takes raw materials and resources through to a finished product for the consumer. The company has to manage costs and ensure standards, being particularly careful that it does not harm people or the environment along the way, from fair wages for labor at the source to recyclable packaging after consumption. Supply chain is big business—in the U.S., 5.75 million people are employed in warehousing and transportation alone.



Raw materials and resources

Whether from a field or a mine, raw materials start somewhere.

Supplier and processor

The raw materials are processed, often near their source.

Manufacturer

Organizations bring resources together to manufacture goods, often near the customer.

64%

of retailers say they had to adapt their supply chain for e-commerce during the COVID-19 pandemic

EXTENDING THE CHAIN

- **Adding value** Companies may try to add value along the chain rather than just seeing it as a way to transport a product from A to B. *See pp.324–325.*
- **Delegating functions** To save money and use specialized expertise, the business can outsource activities and/or have them done by local companies or a branch of its own company offshore. *See pp.326–329.*
- **Returning goods** Part of the supply chain involves an efficient system for dealing with goods returned by the consumer. *See pp.330–331.*
- **Competitive edge** At every stage, the company compares its performance with its competitors to see how it can improve. *See pp.332–333.*
- **Ethics and the environment** Taking responsibility for avoiding pollution and protecting workers' rights is part of the package. *See pp.334–335.*

Distribution
Finished goods are transported to storage depots or retailers.

Retailer
The store displays the products for maximum appeal to the consumer.

Consumer
The consumer enjoys the finished product and, ideally, recycles the packaging.

Value chain

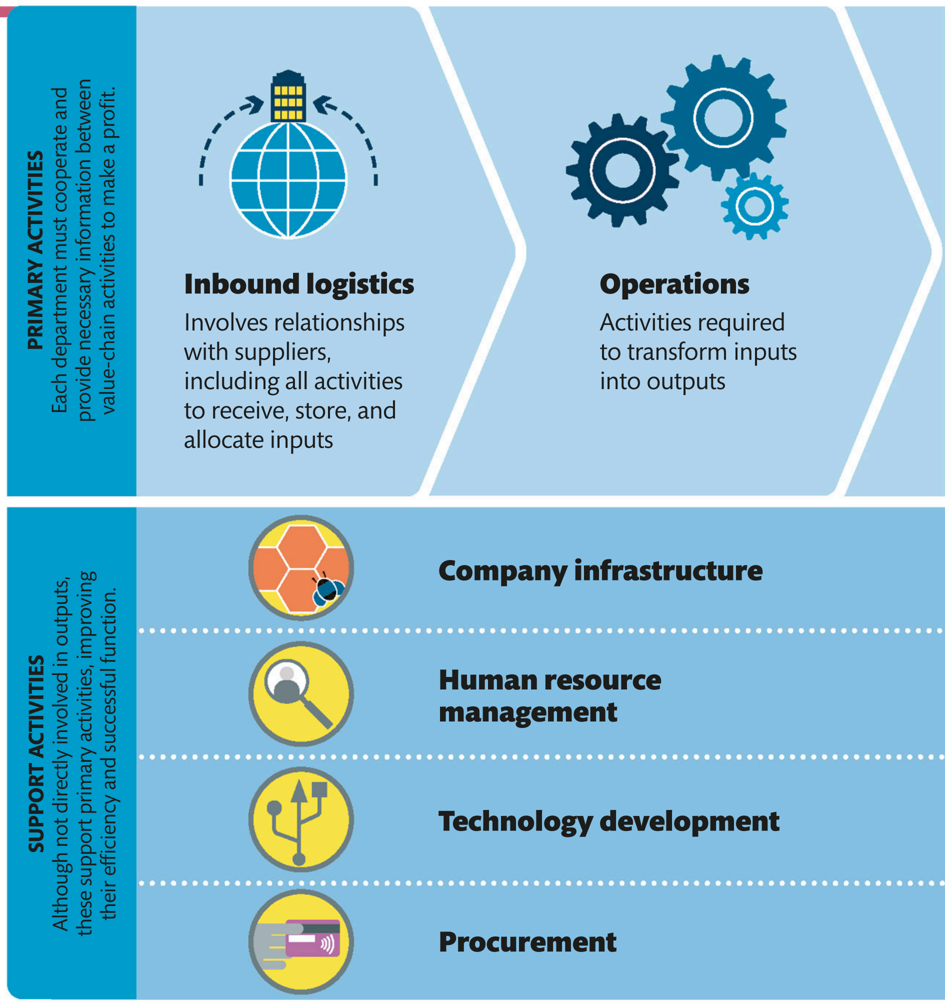
Rather than viewing supply chains as a series of activities, organizations are increasingly paying attention to how value is created at each stage of the process. Lowering costs or raising performance is key.

How it works

Harvard Business School professor Michael Porter first introduced the concept of a value chain in his book *Competitive Advantage*. Most organizations have dozens—possibly hundreds—of activities along the supply chain in the process of converting raw materials (inputs) to products or services (outputs). These can be classified generally as either primary or support activities that all businesses must undertake. The idea of the value chain is that how activities are organized and carried out determines a company's costs and thus its margin (profit). Each link of the chain must communicate to other departments clearly and promptly. For example, marketing and sales must make accurate sales forecasts and pass them on in time for procurement to buy the correct type and quantity of raw materials, which in turn must connect with inbound logistics so it can organize receipt of goods.

Porter's value chain

Primary activities work directly to create or deliver a product or service, while support activities help improve their efficiency. To apply the value chain, a company has to identify each activity and either lower its cost or differentiate it from its competitors to add value in the customer's eye.



CASE STUDY

Zara's value chain

The Spanish clothing brand is famous for rapidly responding to customers' needs along the value chain.

- **Inbound logistics** Bulk fabric orders, quick deliveries
- **Operations** Just-in-time manufacturing, near Spanish HQ
- **Outbound logistics** Twice-weekly store deliveries, low inventory, fast online fulfilment
- **Marketing** Few ads, strategic store locations, store data ensure products match customers' wants
- **Support activities** Tech to supply feedback, customer service training

ONLINE VALUE CHAIN

More than half of the world's population uses the Internet, doing everything from shopping to sharing photos and watching TV, working, and checking social media. To handle this volume, a complex value chain delivers Internet services, made up of global and local firms with assets as diverse as content rights, communications and IT infrastructure, proprietary software, and global brands.

6,384

the number of local Spanish firms supplying Zara's parent company Inditex in 2020

Outbound logistics

Activities required to collect, store, and distribute outputs

Marketing and sales

Activities that inform buyers, encourage purchases, and facilitate transactions

Service

Activities to keep products working effectively for buyers after they are received

Functions such as accounting, legal, finance, planning, public affairs, and quality assurance

People activities: recruiting, hiring, training, developing, compensating, and terminating

Equipment, hardware, software, procedures, and technical knowledge used in transformation of inputs into outputs

Acquisition of inputs (raw materials) for the company

PROFIT MARGIN
Profit equals the customer's willingness to pay more than the sum of all the activities in the value chain.

Outsourcing

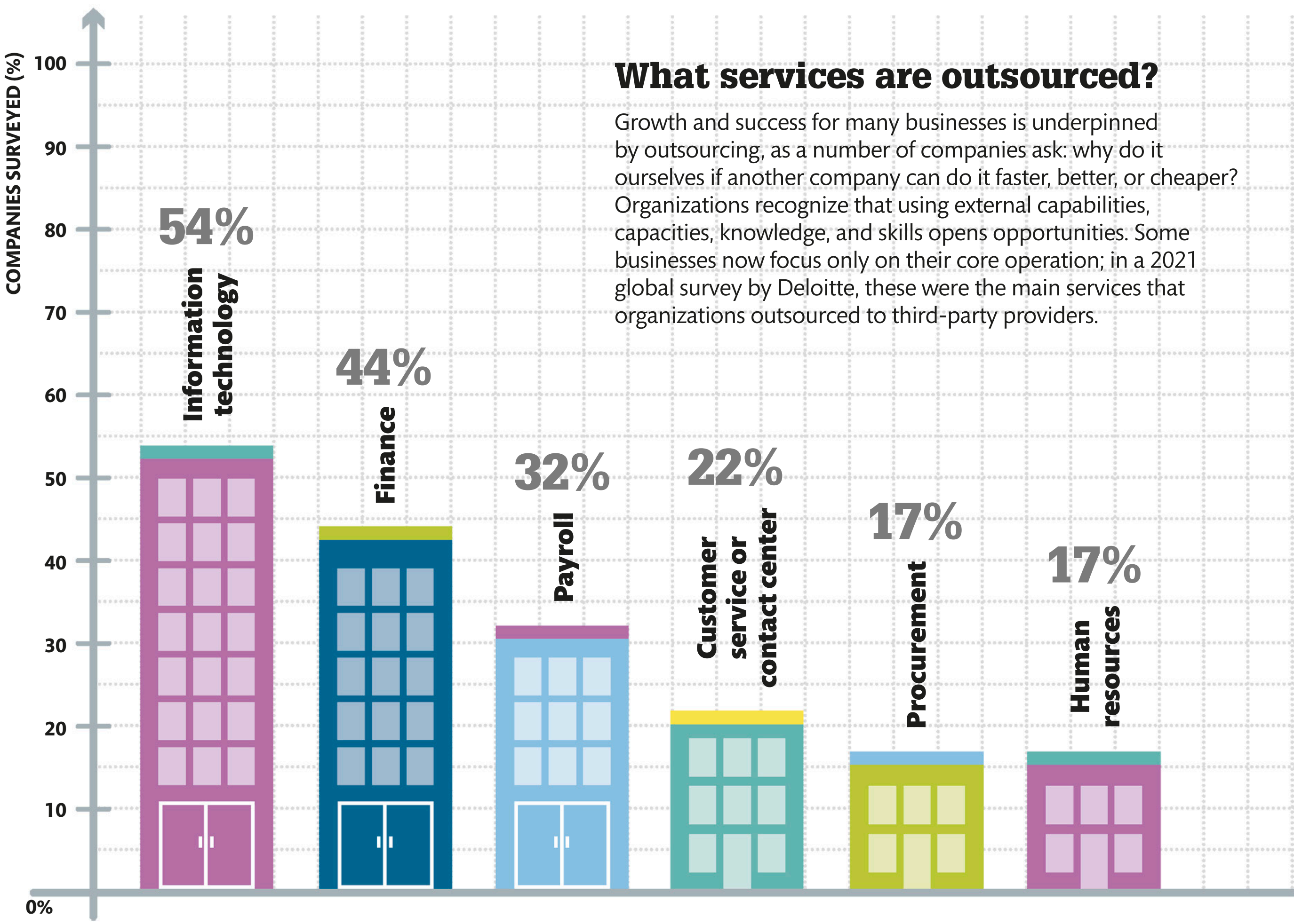
Firms may choose to pay outside suppliers to do work rather than complete the tasks internally. Handing over part or all of production or a service to a third party increases flexibility.

How it works

Outsourcing grew in the 1980s because firms looked to save costs by contracting peripheral business activities to third parties. But outsourcing today is no longer just about cost savings. It is a strategic tool that is increasingly important in the global economy in the 21st century. Businesses may choose outsourcing for elements of the production process; for support functions, such as accounting; or because they do not have the specialized knowledge or skills within the organization. Outsourcing may be to a company in the same country, or it may be to an organization in another country. Rapid expansion of logistics networks and information technology has made it easier to outsource, thus accelerating the growth of outsourcing over the last decade.

What services are outsourced?

Growth and success for many businesses is underpinned by outsourcing, as a number of companies ask: why do it ourselves if another company can do it faster, better, or cheaper? Organizations recognize that using external capabilities, capacities, knowledge, and skills opens opportunities. Some businesses now focus only on their core operation; in a 2021 global survey by Deloitte, these were the main services that organizations outsourced to third-party providers.



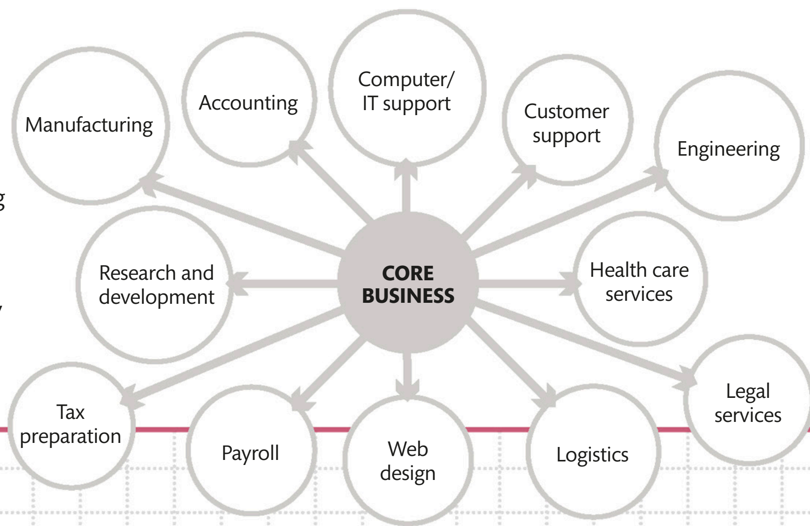
NEED TO KNOW

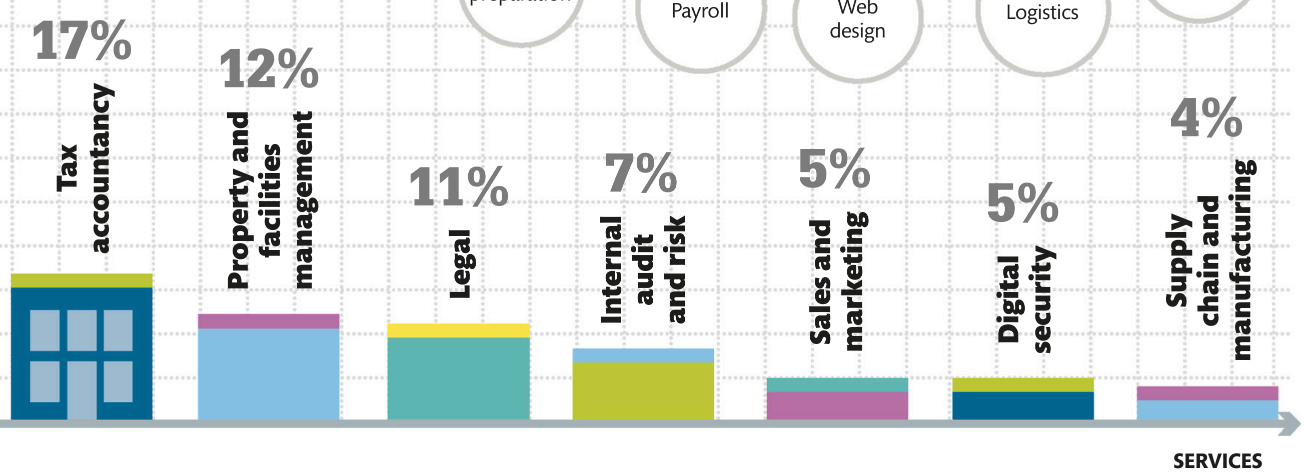
- **Outsourcing** Subcontracting work to another company or buying components for a product rather than manufacturing them.
- **Offshoring** Practice of moving a company's operating base to a foreign country where labor costs are cheaper.
- **Shared services** Practice of moving specific services that were formerly carried out in many parts of an organization (such as HR, finance, and IT) into a single unit. Differs from outsourcing in that no third parties are involved.

80% of firms say they have no plans to move offshore services back in the short term.

EXAMPLES OF BUSINESS TASKS THAT CAN BE OUTSOURCED

Outsourcing certain tasks within a business enables focus to remain on core business activities, which helps generate growth as well as income. Some tasks are better suited to outsourcing than others due to factors including expertise, how time consuming a task is, and how much face-to-face time it requires. IT operations, for example, can be highly expensive, require expert knowledge, and can easily be managed remotely. Human resources, however, is more employee focused and so better kept in house.





Offshoring

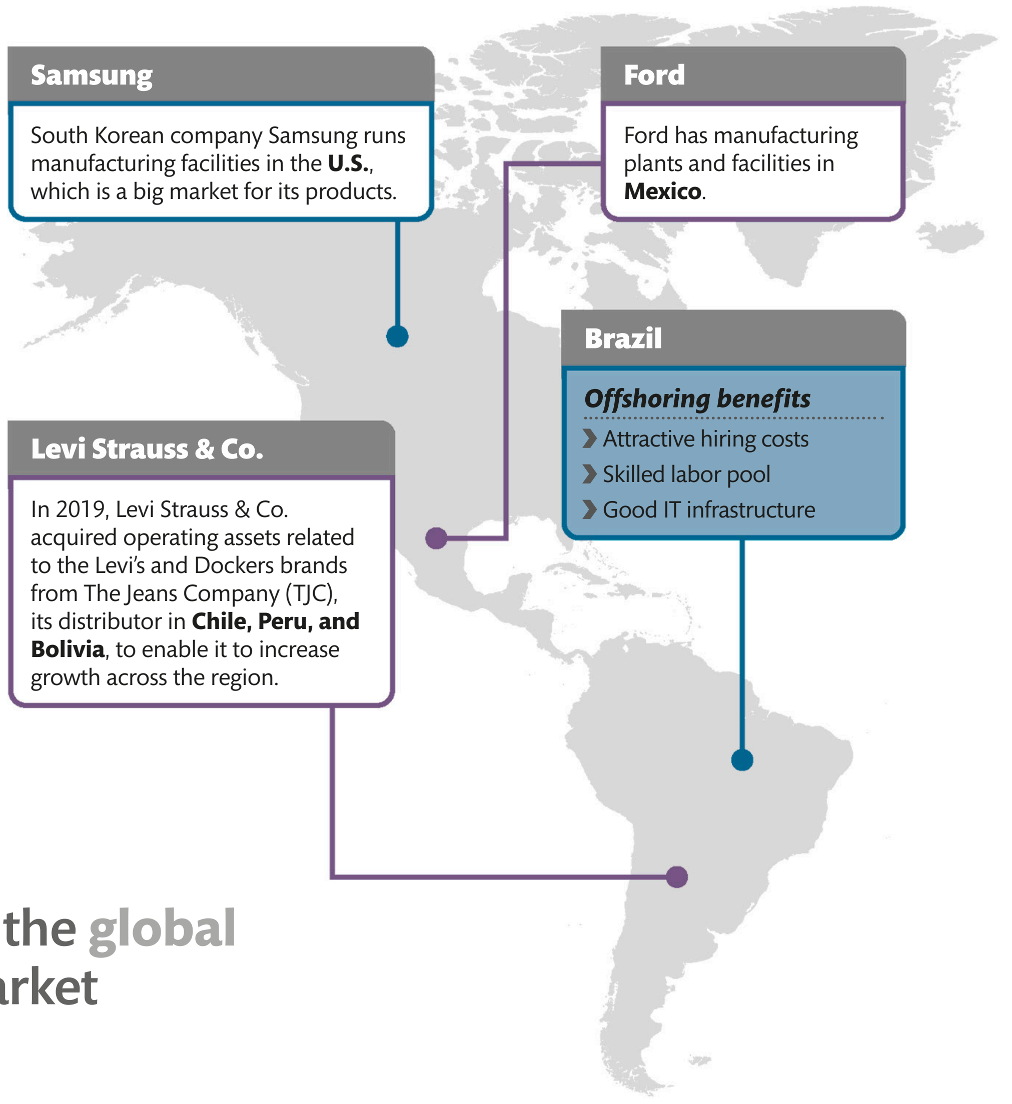
Moving jobs outside the country where a company is based is called offshoring. A company will set up operations overseas and recruit local people to do the work, usually with the support of employees from the parent company.

How it works

Offshoring grew in the 1980s as Western companies with high labor costs realized that they could reap significant savings by manufacturing in countries with lower overheads. Information technology (IT) services followed, enabled by the Internet and global communications. Some firms send manufacturing offshore by setting up a factory in another country—perhaps to be close to a source of raw materials. They can also send services offshore, such as call centers, in locations with a ready supply of skilled staff. In addition, companies can outsource offshore, having work handled by a third party. Firms that send work offshore must follow ethical practices, such as paying local people a fair wage and upholding health and safety standards in the workplace.

Global expertise

Offshoring started in India, and today, it still leads the way. The country's IT and business processing outsourcing export industries employ more than four million people and are worth $147 billion. Other regions have different areas of expertise; for instance, Eastern Europe also specializes in IT services. This map shows examples of the areas of expertise available in different countries, and companies that offshore their operations.



55%

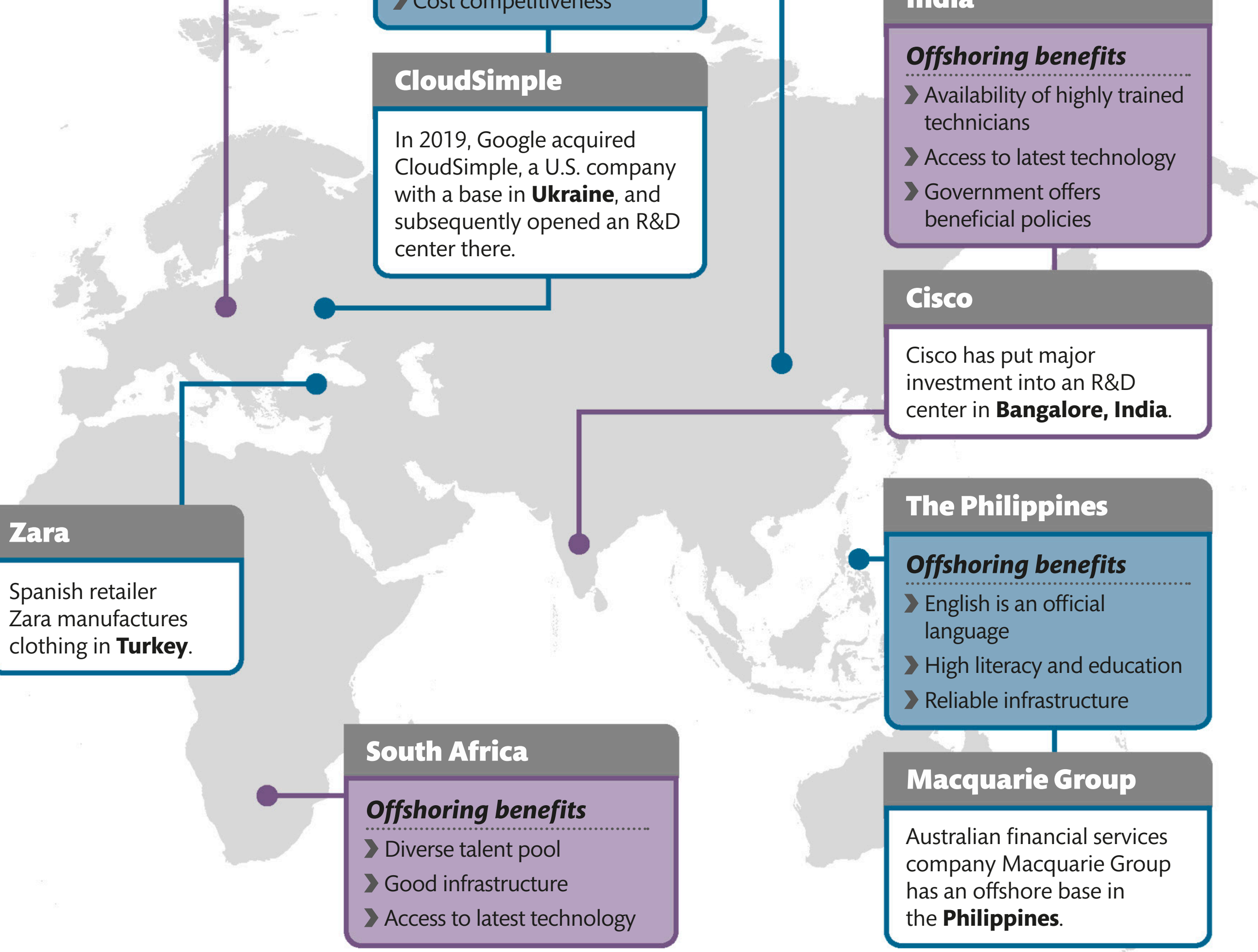
India's share of the global outsourcing market

THE PROS OF OFFSHORING

- Cheaper labor costs
- Proximity to raw materials
- Access to specialized staff
- Tax benefits

THE CONS OF OFFSHORING

- Communication problems
- Working in different time zones
- Different working cultures can cause difficulties
- Can be vulnerable to geopolitical unrest



Jaguar Land Rover

Jaguar Land Rover has a cutting-edge manufacturing plant in **Slovakia**.

Ukraine

Offshoring benefits

- Engineering capability
- Access to people with software development skills
- Cost competitiveness

CloudSimple

In 2019, Google acquired CloudSimple, a U.S. company with a base in **Ukraine**, and subsequently opened an R&D center there.

Apple

Apple has had substantial operations in **China** for many years.

India

Offshoring benefits

- Availability of highly trained technicians
- Access to latest technology
- Government offers beneficial policies

Cisco

Cisco has put major investment into an R&D center in **Bangalore, India**.

Zara

Spanish retailer Zara manufactures clothing in **Turkey**.

The Philippines

Offshoring benefits

- English is an official language
- High literacy and education
- Reliable infrastructure

South Africa

Offshoring benefits

- Diverse talent pool
- Good infrastructure
- Access to latest technology

Macquarie Group

Australian financial services company Macquarie Group has an offshore base in the **Philippines**.

Reverse supply chain

Supply chain takes a product to a customer. Reverse supply chain is the series of activities it takes to retrieve an unwanted or used product from a customer and dispose of, recycle, or resell it.

How it works

Companies have to focus on more than bringing a product to a customer. Now, an efficient reverse supply chain is also essential, especially for the large number of online retailers. Manufacturers, too, in industries from carpets to computers, may need reverse supply to recycle products to meet environmental regulations.

For instance, companies have to manage products that are returned for a refund, products that do not sell and are returned to producers from retailers, or products near the end of their life. In a drive to improve sustainability, Swedish chain Ikea offers to buy back old items of its furniture from customers.

Reverse logistics

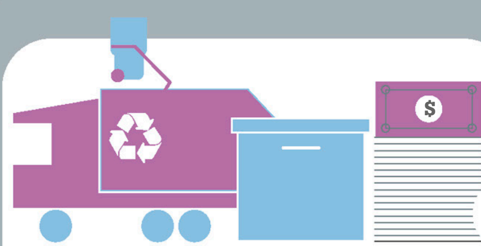
The cost to companies of reverse supply is enormous. For example, in the U.S., statistics from the National Retail Federation show that consumers returned $428 billion of goods in 2020—with online returns almost doubling as consumers switched to Internet shopping during the COVID-19 pandemic. This represents about 10 percent of total U.S. retail sales of $4 trillion for the year.

Retrieve

Companies may have processes in place to collect used or unwanted items, whether from the customer or a retailer.

CUSTOMER RETURNS

Retailers Sears and JCPenney were the first stores to allow consumers to return goods with no penalty. This pioneering move in the late 19th century encouraged people to shop with them and helped build a loyal following. These days, most physical and online retailers allow customers to return unwanted items within a set time period and receive an exchange or refund. Consumers have the right to return faulty goods, which also forms part of the reverse supply chain.



Eventual recycling or reconditioning may be considered at the start of design and manufacturing decisions.

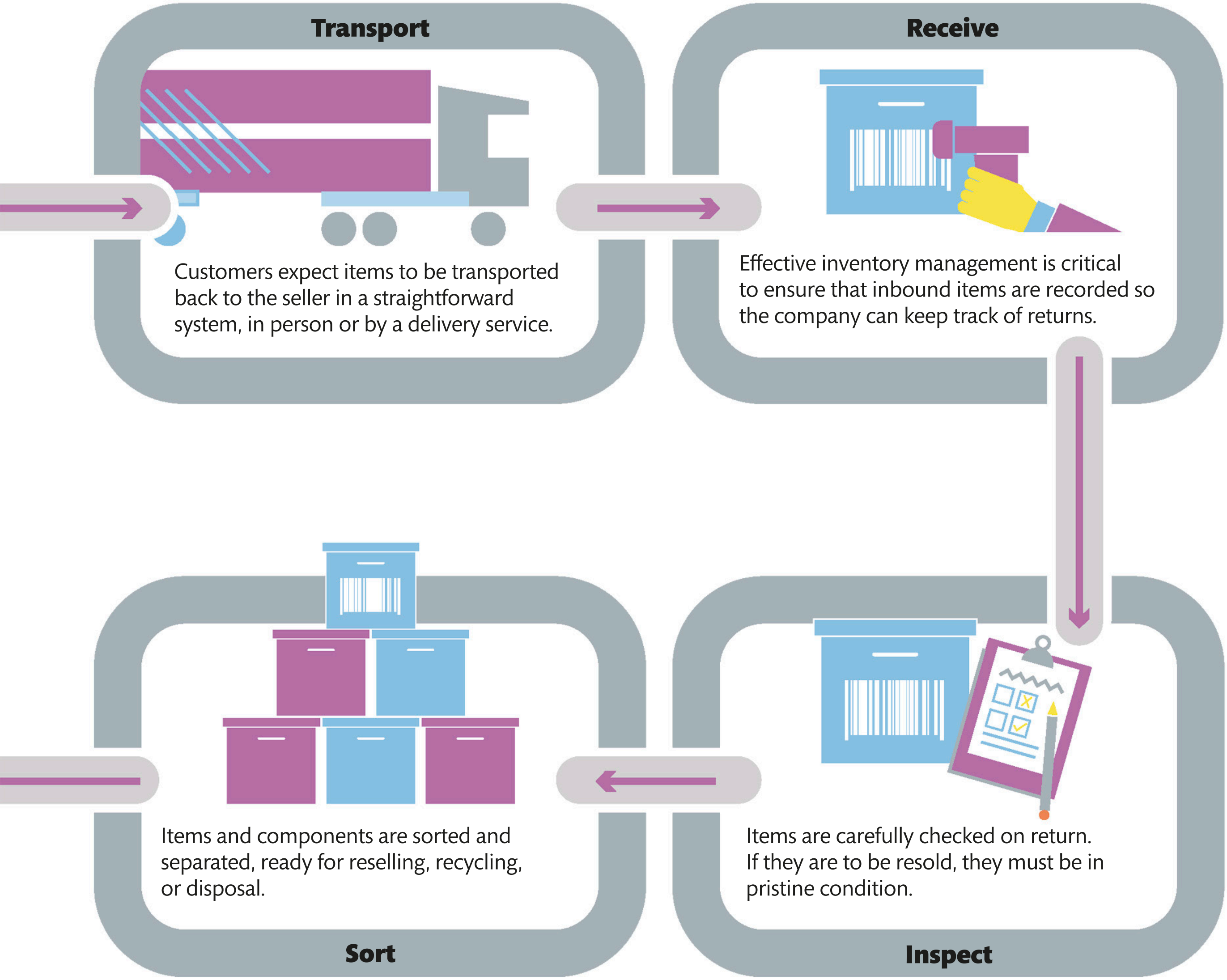
Manage disposal

NEED TO KNOW

- **Electronic waste (e-waste)** Electrical or electronic devices that are unwanted, do not work, or are obsolete
- **Warehousing** Administrative and physical functions necessary for storage of goods, either for selling or retrieval

84%

of Brazilian online shoppers are likely to make an extra purchase when returning an item to a physical store



Benchmarking

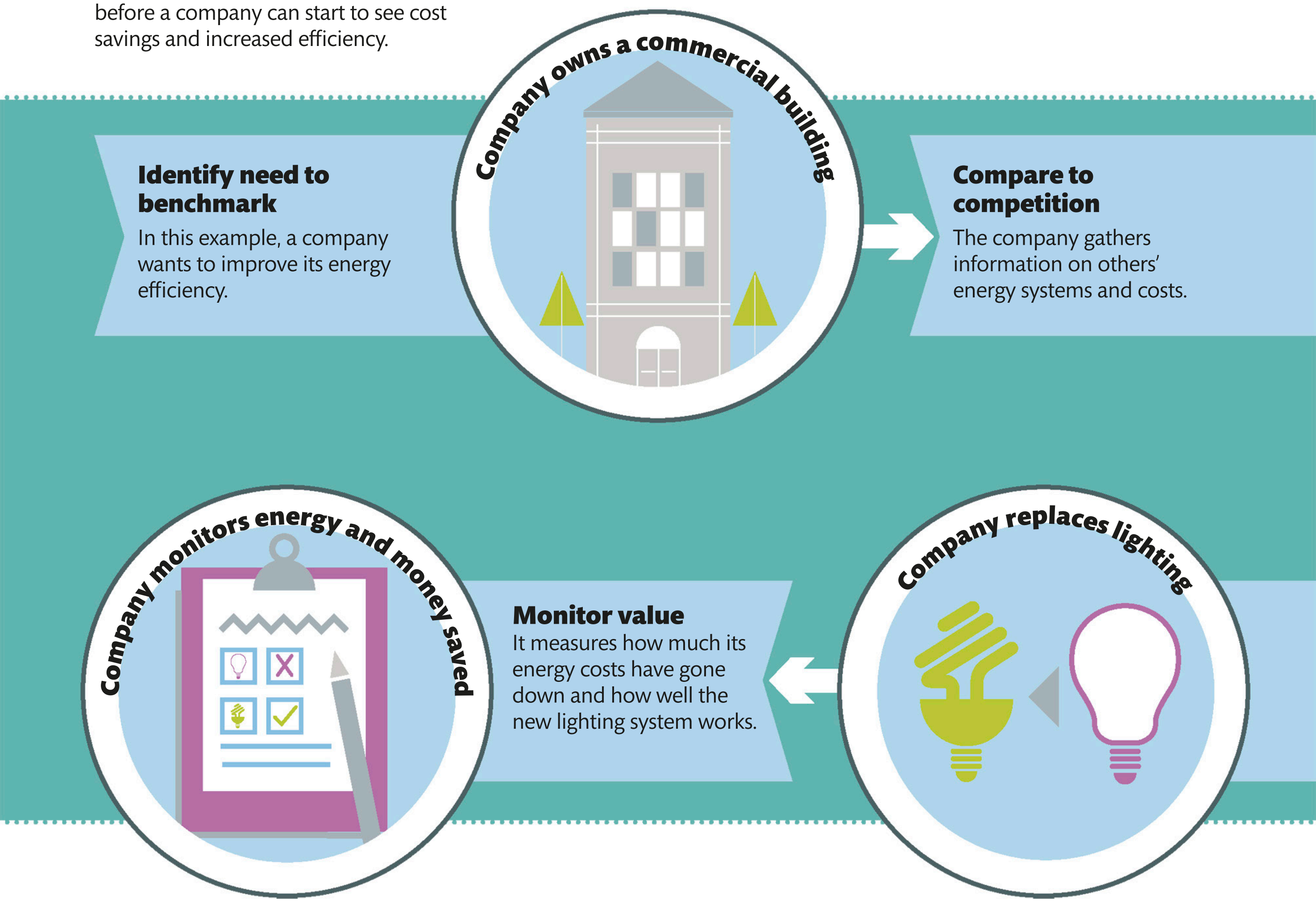
Businesses use benchmarking to improve efficiency by comparing their performance with that of other organizations. The goal is to identify and learn from best practices within or outside the industry.

How it works

To improve results, a business may look outside the organization, industry, or country to explore others' levels of performance and identify how they achieve it. Benchmark areas include unit cost, customer ratings, and pay and benefits. The evaluation takes into account a range of factors, including training, technology platforms, and manufacturing equipment. For example, Formula 1 is often used as a benchmark for teamwork, as pit-stop crews have perfected the changing of four tires in fewer than seven seconds.

The process of benchmarking

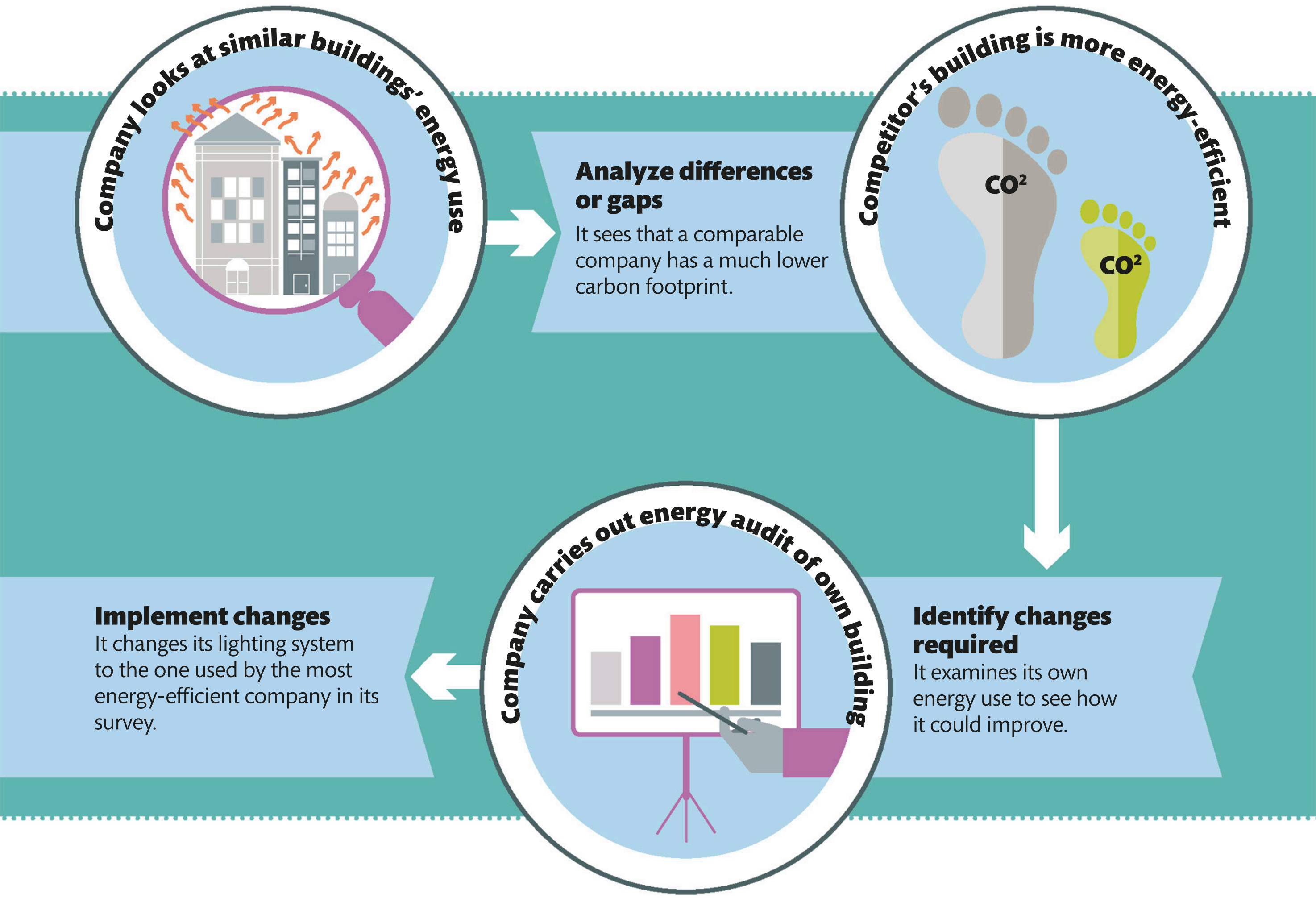
There are several stages to benchmarking performance before a company can start to see cost savings and increased efficiency.



SOCIAL MEDIA MAKES IT EASY

It is now easier than ever for organizations to gather data about their competitors. Social media can provide data on customer preferences, brands, and campaigns of other organizations. Analytical tools are available to simplify benchmarking across many different channels.

> **“Benchmarking is the search for industry best practices that lead to superior performance.”**
>
> Robert C. Camp, ***benchmarking pioneer***



Corporate social responsibility

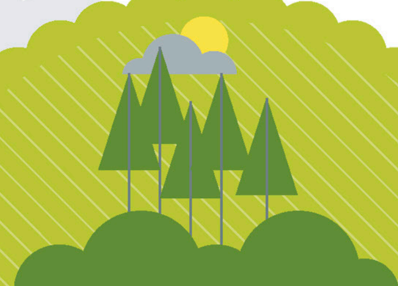
Businesses today must aim not only to do no harm to the environment, people, or communities but also to show commitment to building a better society. This is termed corporate social responsibility (CSR).

How it works

For a business, CSR goes further than aiming to be compliant with national or international regulations, managing risks, or corporate philanthropy—it has to be an integral part of every aspect of operations, helping create a sustainable business. A company still has to be competitive and profitable but must avoid making decisions merely for short-term gain. Instead, it has to consider the future impact on society, the environment, and a wide range of stakeholders. Companies now report annually on how they have met their CSR and are benchmarked and ranked against competitors.

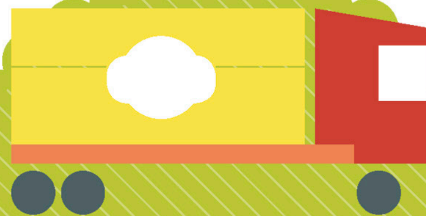
Community
Housing; healthcare; infrastructure; partnering with local institutions; local supplier initiatives; education; training; local employment

100%
of the top 100 companies in Japan and Mexico report on sustainability



Environment
Company's carbon footprint, including recycling; water and waste management; energy use; transportation

Workforce
Workplace safety, health, and well-being; diversity; equal opportunities; learning and development; ethical policies and practices



Suppliers
Fair trade, supply-chain ethics, and sustainability (including use of child labor); code of conduct; transportation policies

CSR stakeholders

A number of different business areas have to be considered in assessing a company's CSR, from how it affects people working in and for the company to wider environmental and community implications.

Operations
Ethical trading, including marketing practices and pricing; managing customers; financial reporting; policies; values

CASE STUDY

AstraZeneca's biogas stoves

The pharmaceutical firm's CSR initiatives include funding a project to test biogas stoves in rural Kenya. The wood and charcoal-fueled stoves traditionally used by many Kenyans release harmful smoke, contributing to climate change and causing respiratory problems in those using them (mostly women and girls). So, the firm partnered with Kenyan company Biogas International and the University of Cambridge's Institute for Sustainability to install smokeless stoves that run on biogas made from organic waste. AstraZeneca also runs other projects targeting ill health in developing countries as well as a health and well-being strategy for its staff.

How companies work

Businesses in the U.S. are registered in the state in which they are headquartered. The government recognizes four business structures: sole proprietorship, partnership, corporation, and nonprofit corporation.

Sole proprietorship

An individual (or married couple) may register their business as a sole proprietorship if they plan to conduct operations on their own. This is the simplest form of business structure. The owner is entitled to all revenues and profits, while maintaining personal responsibility for all debts and liabilities. Income from sole proprietorships is taxed as individual income.

Partnerships

Partnerships are business entities formed by two or more individuals. The most basic form is the general partnership. Partners in a general partnership contribute an agreed-upon share of money, skill, and labor to the enterprise in exchange for a proportionate share of the profits. Liabilities are thusly divided as well. A limited partnership includes general partners and limited partners (also known as silent partners) who share in the profits but whose losses are generally limited to the size of their initial investment. Similar to a general partnership, a limited liability partnership indemnifies one partner from claims arising from other partners' negligence. Lawyers and doctors frequently operate under this structure.

Corporation

Federal and state governments recognize corporations as business entities that are separate and apart from employees and shareholders in terms of income and liabilities. This structure protects management and workers in the case of litigation or other claims but is more complex and subject to greater regulation than a partnership. Such entities must be registered through articles of incorporation. A corporation may be privately held, in which case equity is shared by a limited group of stock owners. A publicly held corporation makes shares available to the public through a stock exchange or through over-the-counter markets.

Limited Liability Company (LLC)

An LLC combines elements of limited partnerships and corporations in a form that is a type of pass-through for sole or multiple owners. It protects the owners from liability, but not as much as a corporation does.

Nonprofit corporation

A nonprofit corporation engages in activities to further the public good, such as works in charitable, scientific, educational, or artistic fields. Such organizations, most frequently registered with the Internal Revenue Service (IRS) through form 501(c)(3), are generally tax-exempt at the federal and state levels. They may, in fact, make profits and pay competitive salaries but are prohibited from engaging in political activities.

In Canada

Businesses in Canada can also be sole proprietorships, partnerships, or corporations. They can also be run as cooperatives, a business that it is owned and controlled by its members. Co-ops are often used by agricultural enterprises. Canadian companies must register in the province or territory in which they are headquartered.

Reporting requirements

Businesses in the U.S. are subject to a range of financial reporting requirements and regulations, depending on structure. Owners of sole proprietorships include income on their individual tax returns filed annually with the IRS. Corporations must also report income to the IRS but are subject to additional requirements.

Privately held corporations must, at a minimum, file charter documents, including name and address, with the Secretary of State in the state in which they are headquartered. Publicly traded corporations are subject to considerably greater disclosure requirements. They must file with the Securities and Exchange Commission quarterly (10-Q) and annual (10-K) reports detailing revenue, income, profits, and losses. They must also file interim reports (8-K) disclosing significant events, such as an acquisition or divestiture, as well as reports (Form 4) that disclose significant buying and selling of shares by company insiders.

Company law

The U.S. Constitution vests in individual states the power to regulate commerce and administer and oversee companies that operate within their borders. States maintain a Department of State or equivalent that acts as registrar for commercial endeavors. Departments of State maintain publicly searchable databases of registered companies, hold administrative hearings, and can take enforcement actions.

Taxation

The IRS collects taxes from businesses on behalf of the federal and state governments. At the time of printing, the federal tax rate on corporations range from 15 to 35 percent. Tax rates vary widely among states, and six states impose no corporate income tax at all.

The federal government and states do not collect Value-Added Taxes (VAT) from businesses, but many states impose sales tax on consumers that businesses collect at the point of sale. Several states have no sales tax. Sales taxes can also vary depending on the item purchased. For example, in New York State, groceries are tax-free, while takeout meals are taxed at the prevailing rate of 4 percent. New York City also applies an additional sales tax of 4.5 percent to most items. Other municipalities around the country are also free to establish their own sales tax rates.

ORGANIZATIONS AND RESOURCES

The Small Business Administration website has information on the corporate structures permitted under U.S. law.
www.sba.gov

Taxation

The Internal Revenue Service provides a number of online services for business owners, including when and where to file tax returns and how to obtain tax credits.
www.irs.gov/businesses

Start-ups

BusinessUSA is a central repository where entrepreneurs can access a range of services. Its website provides information on funding, taxation, hiring, growth strategies, and more. It also offers advice tailored to specific groups, such as women, veterans, and minorities.
business.usa.gov

The U.S. Department of the Treasury also offers advice and services for would-be proprietors. In addition, it operates the Small Business Lending Fund, which secures loans made to business owners by private banks.
www.treasury.gov/Pages/default.aspx

Registering intellectual property

The main arbiter for determining whether a product or business method is worthy of exclusivity is the United States Patent and Trademark Office.
www.uspto.gov

Immigration

All employees must be authorized to work in the U.S. through citizenship or some form of visa. U.S. Citizenship and Immigration Services, part of the Department of Homeland Security, determines visa eligibility and enforces immigration rules.

In Canada

The Canada Business Network offers information about starting and operating a business.
www.canadabusiness.ca/eng/page/2853/
www.entreprisescanada.ca/fra/page/2853/

How finance works

For publicly traded companies, the Securities Exchange Act of 1934 is the framework for financial accounting and reporting. The Securities and Exchange Commission (SEC) enforces the act.

The SEC has established reporting requirements for companies whose shares trade on public exchanges, such as the New York Stock Exchange, the NASDAQ Stock Market, and the NYSE Market LLC. Privately held companies are subject to fewer requirements.

Tax reporting

Both private and public companies must file tax returns with the Internal Revenue Service on an annual basis. The due date varies, based on the filer's status. Sole proprietorships follow the same schedule as individuals and must file by April 15 or request an extension. Partnerships must file by the 15th day of the fourth month after the end of their fiscal year. Public companies must file by the 15th of the third month.

Financial disclosure

Exchange-listed companies must make their financial records publicly available on a quarterly and annual basis, respectively. They must report unscheduled, material events (such as an acquisition or divestiture). Officers and insiders must declare significant purchases or sales of company stock, and the terms of issuance for corporate notes must be detailed.

Regulation Fair Disclosure (Reg FD) stipulates that companies must disseminate financial information simultaneously to all investors. The SEC amended Reg FD in 2013 to include disclosures through social media channels, such as Twitter and Facebook.

Public companies must retain a licensed auditing firm to verify the veracity of their financial records. Under SEC rule 3235-AI74 (2003), auditors must retain client records, including worksheets, financial data, meeting minutes, electronic correspondence, and other materials used to form an opinion, for seven years.

Reporting standards

Companies must log and report financial transactions to the SEC according to Generally Accepted Accounting Standards (GAAP) as established by the Financial Accounting Standards Board, a private, nonprofit organization. Due to the increasingly global nature of business, there is a movement to adopt International Financial Reporting Standards (IFRS).

In the aftermath of several events in recent years, including the bursting of the so-called dot-com bubble; the increased use of controversial financial instruments, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO); and the 2007–2008 financial crisis, the FASB has adopted a number of new rules aimed at restoring order and clarity in the markets.

Accounting periods

For sole proprietorships, the reporting period for tax purposes runs simultaneous to the calendar year. Publicly traded companies may set their own fiscal years. Public companies must file a report for each fiscal quarter as well as a report at the end of each fiscal year. Reports generally must be released within 45 days after the close of a quarter.

Corporate fraud

In addition to its regulatory functions, the SEC, through its Division of Enforcement, is also the U.S.'s chief watchdog when it comes to policing and prosecuting financial fraud. The SEC is mainly on the lookout for several types of misconduct:

False statements. Corporations must report financial information that, to the best of management's knowledge, is complete and accurate.

Insider trading. Corporate insiders, such as officers and executives, can legally buy and sell shares in their companies, but not on the basis of nonpublic information. For example, a CFO cannot unload shares on the basis of negative financial news that has not yet been released. Insiders are also barred from tipping off friends, family, and business associates.

Ponzi schemes. This is the practice whereby a money manager distributes returns to existing investors from funds acquired from new investors. These schemes generally collapse once a fund runs out of fresh capital. The most infamous Ponzi scheme to date is that orchestrated by fund manager Bernard Madoff, starting in the 1990s and continuing until his arrest in 2008.

Pump and dumps. This occurs when a brokerage acquires a large amount of stock, spreads false news meant to increase the stock's value, and then quickly sells its position before the fraud is uncovered.

Front running. This occurs when a brokerage acquires a block of shares in a particular company before executing a large, pending buy order from a client. The client's order, if large enough, will increase the value of the stock, allowing the firm to profit from its foreknowledge of the transaction.

In Canada

The Toronto Stock Exchange is Canada's largest and most commonly used stock market. It is overseen by the Ontario Securities Commission. Stock markets also operate in Vancouver and Montreal.

Businesses operating in Canada must file tax returns with the Canada Revenue Agency. Forms may be filed through the mail or electronically. Unlike in the U.S., the federal government in Canada imposes a value-added tax known as the Goods and Services Tax (GST). The current rate is 5 percent. The tax is levied on manufacturers and producers throughout the chain of production. In some cases, companies can claim tax credits for tax already paid. In some provinces, the GST is included in the Harmonized Sales Tax (HST).

ORGANIZATIONS AND RESOURCES

Financial reporting

The Securities and Exchange Commission provides information on financial reporting requirements for publicly listed companies.
www.sec.gov

The Financial Accounting Standards Board website features educational webcasts and seminars for finance and accounting professionals.
www.fasb.org/home

The Association of Chartered Accountants in the United States offers online training videos, while the CFA Institute maintains a glossary of finance and investment terms.
www.acaus.org

www.cfainstitute.org/pages/index.aspx

Corporate fraud

Those who wish to report corporate fraud may approach the SEC directly through its Office of the Whistleblower.
www.sec.gov/whistleblower

Similarly, the Internal Revenue Service maintains an office through which the public can anonymously report suspected corporate tax cheats.
www.irs.gov

In Canada

The Canada Revenue Agency website has information on the GST and other taxation issues.
www.cra-arc.gc.ca

The Ontario Securities Commission offers a number of online resources for companies considering a listing on the Toronto Stock Exchange.
www.osc.gov.on.ca/

How sales and marketing work

Advertising and marketing in the United States are regulated at the federal and state levels. The Federal Trade Commission (FTC) sets national policies and enforces relevant laws passed by Congress.

The First Amendment to the U.S. Constitution restricts the government's ability to limit or inhibit public speech or communication. However, courts over the years have ruled that commercial speech is subject to less protection than noncommercial speech.

The Federal Trade Commission (FTC) was established in 1914 through the Federal Trade Commission Act. Much of the FTC's work involves enforcing truth-in-advertising regulations, a legislative rubric that requires ads to be truthful, not misleading, and backed by scientific data, if appropriate. In a case of suspected false advertising, the FTC can sue the perpetrator in federal court to obtain a cease-and-desist order, freeze assets, and obtain compensation for victims.

The FTC also enforces legislation aimed at electronic marketing communications, such as email campaigns and telemarketing. For example, the Commission can file suit against agencies suspected of violating the National Do Not Call Registry. Telemarketers are forbidden from calling consumers who have entered their numbers in the registry. Similarly, the FTC enforces the CAN-SPAM Act of 2003, which requires marketers to give consumers a way to opt out of receiving future messages.

The Federal Communications Commission (FCC) also has some authority to regulate commercial speech. For instance, the FCC enforces the CALM ACT of 2012, which stipulates that broadcasters and cable companies must air commercials at the same volume as regular programming.

Individual states can set marketing and advertising rules, particularly for highly regulated industries, such as health care, financial services, and real estate.

At the state level, the Better Business Bureau accepts and responds to complaints regarding companies doing business within state jurisdictions.

In Canada

Freedom of speech and expression in Canada is protected by Section Two of the Canadian Charter of Rights and Freedoms. As is the case in the U.S., commercial speech is afforded less protection than political or other types of expression. Still, the Charter places numerous limitations on the federal and provincial governments' ability to abridge marketing and advertising communications. For example, Canada's Supreme Court in *Ford v. Quebec* (1988) struck down a Quebec law that required all advertising signs to be in French.

Commercial speech in Canada is also governed by the Consumer Packaging and Labelling Act (1985). The law prohibits the use of misleading ads and claims on consumer goods.

Data protection

Unlike Europe, with its centralized Data Protection Directive, the U.S. does not have a single, overarching law on data protection. Rather, Congress has passed a series of laws that together form a framework around the safeguarding of consumers' privacy and information. Many of these rules are directed at particular industries. For example, the Department of Health & Human Services enforces the Health Insurance Portability and Accountability Act of 1996 (HIPAA). The act dictates the administrative, physical, and technical safeguards that health care insurers and providers must follow to protect patient records.

In financial services, the Gramm-Leach-Bliley Act of 1999 stipulates the steps that banks, credit unions, and other financial institutions must follow to safeguard customer data. The act is enforced by the FTC. Other industries are also subject to specific privacy and data protection rules.

Direct marketing

Direct marketing agencies are subject to laws enforced by the above-mentioned agencies but are also supposed to adhere to self-imposed codes of conduct adopted by the Direct Marketing Association. The DMA is a lobby group for the industry that promotes "responsible, data-driven marketing." The DMA develops member policies on a number of issues, including privacy, the environment, e-commerce, and consumer protection.

E-commerce

For marketers that conduct campaigns through the Internet and social media channels, the Interactive Advertising Bureau (IAB) publishes codes of conduct that members are expected to follow. For example, the IAB expects all members to be transparent about the data and personal information they collect from consumers on the Web.

ORGANIZATIONS AND RESOURCES

Advertising

The Federal Trade Commission oversees truth-in-advertising laws and regulations and offers resources to advertisers and marketers to help keep them from breaking the rules. On its website, the FTC publishes advisory opinions on how changes to laws or court rulings may have an impact on future enforcement decisions.
www.ftc.gov/policy/advisory-opinions

The Bureau of Consumer Protection, an arm of the FTC, operates an online Business Center that advises businesses how to comply with Do Not Call, CAN-SPAM, and other rules. It also offers general guidelines on advertising and marketing basics, marketing to children, health claims, and "Made in the USA" claims.
www.ftc.gov/tips-advice/business-center/advertising-and-marketing

Data protection

Various federal agencies can provide information on rules, regulations, and methods concerning the protection of consumer data and privacy, depending on the industry.

The Department of Health & Human Services publishes an online FAQ for complying with HIPAA. It also posts guidelines for covered entities and their business partners and associates.
www.hhs.gov

For marketers and advertisers who work within the financial services industry, the SEC has a Web page devoted to the topic of protecting consumers' financial data and personally identifiable information (PII).
www.sec.gov/about/privacy/secprivacyoffice.htm

In Canada

Canada's Competition Bureau maintains a website that provides in-depth information on the Consumer Packaging and Labelling Act as well as other relevant legislation.
www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/home

How operations and production work

In the U.S., practices concerning corporate governance, responsibility, fiduciary obligations, and social responsibility are broadly governed by the Sarbanes-Oxley Act, passed by Congress in 2002.

Also known as the Public Company Accounting Reform and Investor Protection Act, the Sarbanes-Oxley Act of 2002 (SOX) was passed by Congress in the wake of several high-profile corporate accounting scandals—most notably at Tyco International, WorldCom, Enron, and Enron's auditor, Arthur Andersen.

SOX established the Public Company Accounting Oversight Board (PCAOB), which regulates auditing of corporate financial statements. It prohibits auditing firms from operating consulting businesses and stipulates that a company may not engage an auditor if certain members of senior management worked for that company within the prior year.

SOX requires Chief Executive Officers and Chief Financial Officers to sign and attest to the veracity of their company's financial statements. Board audit committees must have at least one independent director.

In addition to government oversight, the auditing profession has stepped up self-regulation in the wake of the financial scandals. The American Institute of Certified Public Accountants (AICPA) has in recent years issued several key Statements on Auditing Standards (SAS). SAS 70 sets audit standards for the services industry, SAS 85 requires auditors to obtain written representations from management, and SAS 99 details steps to be taken to detect material misstatement and accounting fraud.

In Canada

Businesses in Canada are governed by the Competition Act. The act prohibits misleading advertising and marketing practices and requires truthful statements concerning warranties, guarantees, and prices. It enables wronged parties to sue defendants for fraud in civil court, usually at the provincial level.

Standards and quality control

In the U.S., numerous independent standards organizations play a role in ensuring adherence to standards and quality control in various industries, including manufacturing, services, and health care. Many of these standards are issued by the International Organization for Standardization (ISO), a nongovernmental organization based in Geneva, Switzerland. ISO 9000 sets out eight principles for achieving quality control and operational consistency. ISO 9001 establishes formal processes that companies must adhere to, including the establishment of formal quality-control committees to achieve the designation. ISO 3100 stipulates procedures for controlling and managing risk, while ISO 22,000 concerns food safety.

There are other, privately sponsored quality-control initiatives in which many large U.S. companies participate. Beyond ISO, one of the most widely adhered to is the Six Sigma program, which was developed by Motorola and widely deployed by General Electric under former CEO Jack Welch. Six Sigma seeks to build processes aimed at removing defects from the manufacturing process.

Health, safety, and the environment

Companies operating in the U.S. are expected to operate in a socially responsible manner that attempts to minimize environmental impact while protecting workers' health and safety. The federal Environmental Protection Agency (EPA) has broad authority to interpret, apply, and enforce federal laws concerning environmental impact. The EPA regulates greenhouse gas emissions, estuarial runoff, and wetlands protection, among other things.

To maintain workers' safety, corporations and even small, privately held companies must adhere to standards set by the Occupational Safety & Health Administration (OSHA). OSHA regulations require a workplace that keeps workers safe from everything from slips and falls to major industrial hazards, such as exposure to toxic chemicals. OSHA has the power to halt production at job sites deemed unsafe.

Food production and processing are further subject to health and safety standards set by the Food and Drug Administration (FDA) and the U.S. Department of Agriculture's Food Safety and Inspection Service.

Liabilities, warranties, and guarantees

Companies that sell goods and services in the United States must adhere to various consumer protection laws that are generally issued and enforced at the state level. For example, New York State maintains a Division of Consumer Protection, California has its Department of Consumer Affairs, and the Texas Attorney General maintains a Consumer Protection unit. These organizations enforce laws concerning the terms and conditions under which goods and services are sold to the public. New York State, for instance, requires stores to post their refund policies in open view, maintain transparent rebate policies, and limit restrictive provisions on gift card redemption.

Intellectual property law and patent protection

Intellectual property laws in the U.S. are upheld and enforced mainly through the U.S. Patent and Trademark Office (USPTO) and the U.S. Copyright Office.

The USPTO adjudicates the validity of patent claims and awards patents on new designs of products, services, and business methods. The USPTO also evaluates trademark claims.

The Copyright Office registers claims and issues certificates for copyrights on literary, artistic, and design works, such as a corporate logo.

ORGANIZATIONS AND RESOURCES

Compliance and corporate responsibility

The Securities and Exchange Commission enforces Sarbanes-Oxley compliance.
www.sec.gov

Standards and quality control

ISO's site provides full information on all the standards overseen by the organization.
www.iso.org/iso/home.html

Health, safety, and the environment

OSHA's website offers information on new regulations, compliance tips, and enforcement actions.
www.osha.gov

The EPA has online tools for checking compliance with federal environmental regulations.
www3.epa.gov

Information on food safety laws and practices can be obtained from the FDA's site.
www.fda.gov

Liability, warranties, and guarantees

In the U.S., consumer protection generally falls to the state. Individual state websites provide information on regulations concerning public sales of goods and services.

Intellectual property law

The USPTO is the main resource for all information concerning the filing of patent applications.
www.uspto.gov

The U.S. Copyright Office website includes information about the copyright process and fees.
copyright.gov

In Canada

Information on corporate law and operations in Canada can be obtained from the federal government's Competition Bureau.
www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/home
www.bureaudelaconcurrence.gc.ca/eic/site/cb-bc.nsf/fra/Accueil

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